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Practical Risk Management for Trustees and Other Fiduciaries

Office of Continuing Legal Education at the University of Kentucky College of Law

UK CLE

PRACTICAL RISK MANAGEMENT FOR TRUSTEES AND OTHER FIDUCIARIES

July 2005

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July 2005

Presented by
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW

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PRACTICAL RISK MANAGEMENT FOR TRUSTEES AND OTHER FIDUCIARIES

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SECTION A

KENTUCKY PRINCIPAL AND INCOME ACT

KENTUCKY PRINCIPAL AND INCOME ACT

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I. INTRODUCTION

Following passage by the General Assembly, the Kentucky Principal and Income Act (the "Kentucky Act") became effective on January 1, 2005. It is set out in KRS 386.450 through .504. The Kentucky Act contains most (but not all) of the provisions of the 1997 Revised Uniform Principal and Income Act (the "Uniform Act"), and many of these are a substantial departure from prior law concerning principal and income determinations. Included in the Kentucky Act are three provisions of significant note:

(1) KRS 386.454, which grants the trustee the authority to adjust between principal and income, (a) is applicable only where the trustee is investing as a prudent investor (more discussion later), (b) includes payment of a unitrust amount as a method of adjustment, and (c) requires beneficiary consents and District Court approval;

(2) Subsection (6) of KRS 386.454 authorizes a fiduciary, with District Court approval, to divide a trust into two or more separate trusts on a fractional basis, if there is no change in any beneficial interests; and

(3) KRS 386.464 permits the settlor of a trust to change the charitable beneficiary by Will or by written notice to trustee or decline to make a change in like manner.

As noted, many other changes wrought in the Kentucky Act are a substantial departure from prior law. Much of this is due to the fact that prior law was based upon the Revised Uniform Principal and Income Act that was promulgated in 1962. Of course, entities such as S corporations and limited liability companies did not exist then. Nor did retirement vehicles such as 401(k) benefit plans and IRAs. The Kentucky Act deals with all of these.

One provision of prior law doesn't appear in the Uniform Act or the Kentucky Act because it should no longer be necessary. Prior KRS 386.295 dealt with payment of delayed income upon the sale of underproductive property (property that didn't produce annual income of 1% of its inventory value). Under the Kentucky Act, KRS 386.488(2), proceeds received upon the sale of an asset are principal regardless of how much income the property produced. However, with the trustee's authority to allocate between principal and income (with District Court approval), old KRS 386.295 should not have any relevance in the administration of a trust.

II. TRUSTEE'S POWER TO ALLOCATE

The Uniform Act empowers the trustee (and the personal representative of an estate) to adjust between principal and income so as to enable the trustee to implement modern portfolio theory under the prudent investor rule[1], which looks at trust investing on a total return basis with less emphasis on traditional notions of income and principal. As note in the Comments to the Uniform Act:

[1] The Uniform Prudent Investor Act has not been enacted in Kentucky. However, there is a brief statement of the prudent investor rule in KRS 287.277 (Appendix A) that is applicable to corporate trustees, and non-corporate (individual) trustees may elect to have the prudent investor rule apply under KRS 386.454(1).

> Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of a trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too big because of investment decisions made by the trustee under the prudent investor rule.

The Kentucky Act in KRS 386.454(2) provides that a trustee may adjust between principal and income if

(1) KRS 287.277 applies by law or by election (which may be made under Section (1) with District Court approval);

(2) the trust describes the amount that may or shall be distributed to a beneficiary with reference to the trust's income; and

(3) the trustee is unable to administer the trust impartially with respect to all beneficiaries.

The Kentucky Act limits the trustee's power to adjust by requiring the approval of the District Court. In the definitional section of the Kentucky Act, this is defined to mean the consent of all current beneficiaries, all remainder beneficiaries in the oldest generation, and the district court. KRS 386.450(3). In contrast to the Uniform Act, which grants full discretion to the fiduciary, the Kentucky Act subjects the exercise of discretion to the consensus of a group. This is a substantial departure from the Uniform Act, and it came about because the General Assembly was uncomfortable with granting too much discretion to fiduciaries.

The power to adjust includes conversion to an annual unitrust payout of 3% - 5% of the annual value of the trust's assets. The range of 3% - 5% was derived from regulations promulgated under section 643(b) of the Internal Revenue Code of 1986, as amended (the "Code").[2] The regulations specifically state that a unitrust amount of 3% - 5% is a reasonable apportionment of the total return of a trust. Treas. Reg. 1.643(b)-1.

Several questions have arisen concerning the district court proceeding:

1) Who are the remainder beneficiaries in the oldest generation? For example, if the spouse is the current beneficiary and two children (both over age 18) are the equal remainder beneficiaries if they survive this spouse (but if not, to their descendants), it is clear that the two children are the remainder beneficiaries in the oldest generation.

Change the facts slightly so that one child is deceased but has surviving minor children. Is the surviving child the remainder beneficiary in the oldest generation or must the minor children of the deceased child be included in the proceeding? The answer should be that only the surviving child must consent, but it could be argued that there are two separate remainder interests.

2) The statute states that a unitrust percentage is to be applied to the annual value of the trust assets. Does this authorize an average of three preceding year ends or 12 preceding calendar quarters?

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[2] These regulations were drafted to authorize a fiduciary to include capital gains in distributable net income for fiduciary income tax purposes, where the fiduciary is exercising a power to adjust. These will be discussed later in detail.

3) With a dynasty trust lasting for the full period of the Rule Against Perpetuities, who are the remainder beneficiaries? A guardian ad litem will be necessary in this situation.

4) What is the impact of the new statute, if any, for a traditional trust that was converted to a total return trust prior to January 1, 2005, and is paying greater than a 5% unitrust amount?

III. CODE SECTION 643(B) - THE NEW REGULATIONS

Capital gains are generally excluded from distributable net income for fiduciary income tax purposes, and this rule has been in place for many years under Section 643 of the Code and its regulations. The new regulations are effective for tax years of trusts and estates ending after January 2, 2004. The changes in the regulations were generated as a result of changes in state laws concerning the prudent investor rule and the Uniform Act. Under certain circumstances, fiduciaries may allocate capital gains to "distributable net income", and the gains then will pass to the beneficiary as part of the distribution deduction calculated on the income tax return for the trust.[3] Treas. Reg. 1.643(a)-3(b)(1) states:

> Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by local law--
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and

[3] Capital losses are first netted at the trust level against gains. Treas. Reg. 1.643(a)-3(d).

> the amount so allocated may not be greater than the amount of distributable net income determined without regard to this subparagraph §1.643(a)-3(b)) (emphasis added.);

Two of the examples in the regulations deal with payments of a unitrust amount where there is no state law concerning the ordering of the character of the payment (i.e., no rule stating that the unitrust amount is considered to be paid from various types of income in a certain order, as under the Kentucky Act), one with the trustee determining to include capital gains in distributable net income and the other not. Both are all right, but the trustee must be consistent in its treatment of capital gains from year to year. The Kentucky Act does not specifically grant discretion to the trustee concerning allocation of capital gains to distributable net income, so the trustee likely will want to address this matter in any petition to reform a trust.

Other tax issues are addressed in the new regulations and in amendments to regulations under other Code sections. These are:

1) A switch between methods of determining income that is authorized by state law will not constitute a recognition event for purposes of Code Section 1001. Treas. Reg. 1.643(b)-1.

2) A switch between methods will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. Treas. Reg. 1.643(b)-1.

(3) A trustee will be treated as having sold property that is distributed in kind to a beneficiary entitled to receive all income. The amount realized is the fair market value of the property on the date of distribution. Treas. Reg. 1.651(a)-2.

4) Gain or loss is similarly realized by a trust where the trustee distributes property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of property other than that distributed, or of income (if the income is required to be distributed). Treas. Reg. 1.661(a)-2.

5) The regulations under both Code sections 2056(b)(5) (general power of appointment trust for spouse) and (b)(7) (QTIP trust for spouse) are amended to the effect that qualification for the marital deduction is not adversely affected where the trustee distributes income that meets the requirements of Treas. Reg. 1.643(b)-1.

(6) A trust that is grandfathered for generation-skipping tax purposes will not lose its exempt status by converting an income interest to a unitrust interest that is authorized under state law. Treas. Reg. 26.2601-1(b)(2).

IV. DECEDENTS' ESTATES AND TERMINATING INCOME INTERESTS: DETERMINATION OF AND ENTITLEMENT TO NET INCOME

A. Determination and distribution of net income in the case of an estate and after an income interest in a trust ends.

KRS 386.456(1) provides that a beneficiary who receives specific property will receive the net income and net principal attributable to such property as determined under normal income/principal rules.

Section (2) states that remaining net income will be determined under normal income/principal rules and by - -

--Including in net income all income from property used to discharge liabilities;

--Paying from income or principal in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries; court costs and other administration expenses (but expenses may be paid from income only if such payment will not reduce the marital or charitable deduction); and

--Paying from principal all other disbursements made in connection with settlement of an estate or winding up a terminating income interest.

According to the Comments, the fiduciary is granted discretion in connection with certain expenses above so that the need to make compensating adjustments will not be necessary. For example, if the fiduciary pays an expense out of income which the fiduciary has determined to deduct on the income tax returns of the estate or trust, then no adjustment between beneficiaries would be necessary (i.e., the income beneficiary bore the expense and received the benefit of its payment).

Section (3) puts on the same footing beneficiaries of specific dollar amounts from estates <u>and</u> trusts by providing that the beneficiary under the trust agreement will receive the same payment of interest that the beneficiary under a Will would receive. Under KRS 394.520, the beneficiary of a pecuniary bequest under a Will is entitled to interest if payment is made more than one year after the Will is probated.

B. Distributions to Residuary and Remainder Beneficiaries.

KRS 386.458(4) states than an income interest ends on the day before an income beneficiary dies. This new section also includes a specific provision for calculating a fractional interest upon distribution. Prior law specified the use of "inventory value" in making such calculation. The new law appears to be more in line with accepted practice to the effect that, absent contrary instruction in the governing document, the value of the fractional interest is determined using date of distribution values.

C. KRS 386.462 - Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins.

--An income receipt or disbursement will be allocated to principal if the due date occurs before the decedent's death (in the case of an estate) or before an income interest begins (in the case of a trust).

--An income receipt or disbursement is allocated to income if, its due date occurs after the decedent's death or an income interest begins and it is a periodic due date. If there is no periodic due date or the payment has no due date, then the income receipt or disbursement is treated as accruing from day to day. Amounts accrued to the decedent's death or before the income interest begins are allocated to principal and the balance of a payment is allocated to income.

--What is the due date of a payment? Normally, it is the date on which the payer is required to make payment. Distributions to shareholders or other owners from an entity to which KRS 386.466 applies are deemed to be due on the "record date" or, if there is none, on the declaration date. Due dates for lease rentals and interest on obligations are considered to be periodic.

D. KRS 386.464 Apportionment When Income Interest Ends And Definition of Undistributed Income.

--"Undistributed income" means net income received before the date on which an income interest ends. It does not include income or expense that is due or accrued or net income that is required to be added to principal.

<u>V. ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF A TRUST</u>

A. KRS 386.466 deals with receipts from entities.

"Entities" are defined as corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds or any other organization in which the trustee has an interest (other than an estate or trust).

Generally, <u>money</u> received from an entity is income.

A trustee is required to allocate the following receipts to principal:

--Property other than money received from the entity.

--Money received in one or several related distributions in exchange for <u>part or all</u> of the trustee's interest in the entity.

--Money received in total or partial liquidation of the entity.

--Money received from a RIC or a REIT if the money is a capital gain dividend for federal income tax purposes. As the Comments note, net short-term capital gain is not included as a "capital gain dividend" under the Code and, therefore, is allocated to income.

--Per the Comments, reinvested dividends are treated as principal if the trustee elects to reinvest dividends under KRS 386.454 (with District Court approval).

--Money is received in partial liquidation if such is indicated by the entity or if the distribution(s) exceed 20% of the entity's gross assets.

--Money is <u>not</u> received in partial liquidation to the extent it does not exceed the amount of income that a trustee or beneficiary will pay on the taxable income of the entity.

--The trustee may rely on a statement from the entity's board of directors (or similar person or group of persons) as to the source or character of the distribution.

B. KRS 386.470 deals with principal receipts.

--Amounts received from a transferor during life are allocated to principal.

--The same is true for amounts received from a decedent's estate and amounts received on life insurance and annuity contracts.

--Money received from the sale, exchange, or liquidation of a principal asset, including stock splits and realized profit.

--Proceeds of property taken by eminent domain. But, if there is a separate award for loss of income during a period where a current beneficiary had a mandatory income interest, such award will be income.

--Amounts received for options granted or paid for options acquired are allocated to principal. The same is true for gain or loss realized upon the exercise of options.

C. KRS 386.472 concerns receipts from rental properties.

--Rent is income. Amounts received for renewal or cancellation of a lease are as well.

--Refundable deposits are added to principal.

--Some amounts paid under a lease may be reflective of capital improvements and, according to the Comments, the trustee may want to make a transfer from income to principal under KRS 386.496

D. Receipt from obligations to pay money are dealt with in KRS 386.474.

--Interest is allocated to income. This includes receipt of a prepayment penalty. Premiums paid on obligations are not to be amortized.

--Amounts received from the sale or redemption of an obligation that matures more than one year after purchase are allocated to principal, even if the original purchase price was less than the obligation's maturity value. If the maturity date is less than one year after purchase, an amount received in excess of the purchase price is allocated to income.

--This section is not applicable to an obligation to which KRS 386.472 (receipts from rental property), .480 (receipts from deferred compensation, annuities, or similar payments), .482 (receipts from a liquidating asset), 484 (receipts from mineral, water, or other natural resources), or .486 (receipts from timber) applies.

E. KRS 386.476- insurance policies and similar contracts.

--Where the trustee is named as a beneficiary of a life insurance policy or other contract, including property and casualty policies and title insurance policies, proceeds are allocated to principal.

F. KRS 386.480 deals with receipts from deferred compensation, annuities, and similar payments.

--Included in this section are private or commercial annuities, individual retirement accounts, and pension, profit-sharing, stock bonus, or stock-ownership plans.

--The term "payment" means a payment over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred in exchange for future payments.

--If a payment is designated as interest or dividends (or as made in lieu of interest or dividends), the trustee will allocate such payment to income. The balance is allocated to principal.

--If no designation is made <u>and all or part of the payment is required to be made</u>, the trustee will allocate to income 10% of the portion of the payment that is required to be made and the balance will be allocated to principal.

--If no part of the payment is required to be made or the payment is the entire amount to which the trustee is entitled, the entire payment is allocated to principal.

--If a larger portion of a payment is required to be allocated to income in order for the trustee to obtain the marital deduction, the trustee will make such allocation.

G. KRS 386.482 concerns principal/income treatment of receipts from liquidating assets.

--"Liquidating assets" are leaseholds, patents, copyrights, royalty rights, and the right to receive payments for a period greater than one year under an arrangement that does not provide for the payment of interest. Ten percent of amounts received are allocated to income.

H. 386.484 - Receipts from natural resources.

--Most receipts are allocated 90% to principal and 10% to income.

--If an interest in water is renewable, the receipt is allocated to income.

--Proceeds from disposition of an interest are allocated in the same manner as receipts.

--If the interest is held in trust on 1-1-05, the trustee is granted discretion to allocate the receipts in the manner utilized by the trustee prior to that date.

--In determining the allocation of receipts under the new Kentucky law, it does not matter whether the minerals or other natural resources were being extracted before or after being placed in trust.

I. The rules concerning receipts from timber are set forth in KRS 386.486.

--Receipts are allocated to income to the extent that the timber removed does not exceed the growth rate during a beneficiary's mandatory income interest. Receipts in excess of the rate of growth are principal, as are proceeds from the sale of standing timber. The trustee is required to allocate to principal a reasonable depletion allowance. As with natural resources, it does not matter whether the timber was being harvested prior to being placed in trust. Also, the trustee has the option of using the prior method on existing timber interests, but must apply the new law on timber interests acquired in the trust after 1-1-05.

J. Pursuant to KRS 386.478, amounts received to which .480, .482, .484 or .486 is applicable may be insubstantial, and the trustee may determine to allocate the entire amount to principal.

--An amount is presumed to be insubstantial if (1) the amount of the allocation would increase or decrease net income (as determined before the allocation) during the accounting period by less than 10%, or (2) the value of the asset producing the receipt is less than 10% (at the beginning of the accounting period) of the value of the trust's assets.

VI. ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

A. Disbursements from income are governed by KRS 386.490, and the rules for disbursements from principal are contained in KRS 386.492.

--1/2 of the trustee's regular compensation is paid each from principal and income. This includes costs of investment advisory or custodial services provided to the trustee.

--1/2 of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests is paid each from income and principal.

--Trustee's compensation calculated on principal as a fee for acceptance, termination, or distribution is charged to principal.

--Disbursements to prepare property for sale are charged to principal.

--Payments on the principal of trust debt are paid from principal.

--Expenses of a proceeding that primarily concerns principal, <u>such as a proceeding to construe a trust</u> or to protect the trust or its property, are paid from principal.

--Premiums on insurance to cover the loss of a principal asset or loss of income from the use of the asset are charged to income and other insurance premiums are paid from principal (per the Comments, such as title and life insurance premiums).

--Death taxes (including penalties apportioned) to a trust are charged to principal. Per the Comments, GST taxes are included.

--Disbursements concerning environmental matters are charged to principal.

--All other ordinary expenses concerning administration, management or preservation of trust property and the distribution of income are charged to <u>income</u>. These include interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding that primarily relates to the income interest.

B. KRS 386.494 deals with transfers from income to principal to cover depreciation.

--The trustee is authorized to make such transfers, but need not create a separate fund.

No transfer may be made for a residence or personal property that is used by the beneficiary or during the administration of a decedent's estate.

C. KRS 386.496 concerns transfers from income to principal in order to regularize income disbursements over a period of years.

--An example would be a large planned expenditure from principal for which the trustee would expect to create a depreciation reserve. Rather than make abnormally large transfers from income to principal following the expenditure, this provision authorizes the trustee to make transfers from income to principal with the expected expenditure in mind.

D. KRS 396.498 - Payment of income taxes.

--If a receipt is allocated to income, the tax on that receipt is paid from income.

--Similarly, the tax on receipts allocated to principal are paid from principal.

--Tax on income from an entity depends upon whether the receipts from the entity are allocated to income or principal.

E. Adjustments between principal and income due to taxes are dealt with in KRS 386.500.

--A typical example, per the Comments, involves deducting a principal expense (that could have been deducted on the federal estate tax return) on an income tax return.

--With a QSST, where all of the income of the S corporation is taxable to the income beneficiary, the trustee may transfer principal to income (for ultimate distribution to the income beneficiary) if the cash distribution from the S corporation is not sufficient to cover the beneficiary's income tax liability.

--Under the Kentucky Act, the above adjustments require District Court approval.

--Subsection (2) requires a mandatory adjustment from income to principal if the marital or charitable deduction is reduced because the fiduciary deducts an amount paid from principal on an income tax return and the estate tax is increased and the income tax is decreased.

VII. APPLICABILITY TO EXISTING TRUSTS

A. Unless provided otherwise in the instrument creating the trust, the Kentucky Act applies to all trusts administered under Kentucky law no matter when created.

B. KRS 386.502 reiterates that the trustee's authority to adopt the prudent investor rule and to make allocations to income (KRS 386.454) is strictly subject to District Court approval.

APPENDIX A

287.277 Standards for bank or trust company acting as fiduciary.

(1) Notwithstanding the provisions of any other law, a bank empowered to act as a fiduciary or trust company, when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property held in a fiduciary capacity, shall act as a prudent investor would, in light of the purposes, terms, distribution requirements and other circumstances of the fiduciary account.

(2) The standard described in subsection (1) of this section requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the account portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the account.

(3) In making and implementing investment decisions, the bank or trust company has a duty to diversify the investments of the account unless, under the circumstances, it is prudent not to do so.

(4) In addition, the bank or trust company shall:

(a) Conform to fundamental fiduciary duties of loyalty and impartiality;
(b) Act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and
(c) Incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the account.

(5) The duties of the bank or trust company under this section are subject to the rule that in investing the funds of the account, the bank or trust company:

(a) Has a duty to the beneficiaries of the account to conform to any applicable statutory provisions governing investment by fiduciaries; and
(b) Has the power expressly or impliedly granted by the terms of the account or applicable instrument and has a duty to the beneficiaries of the account to conform to the terms of the account directing or restricting investments by the bank or trust company.

Effective: July 15 1996
History: **Created** 1996 Ky. Acts ch. 338, sec. 6, effective July 15 , 1996.

DRAFTING FOR AND MAKING DISCRETIONARY DECISIONS AND DISTRIBUTIONS

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DRAFTING FOR AND MAKING DISCRETIONARY DECISIONS AND DISTRIBUTIONS

I. The Underlying Issue: Wealth And How To Use It Wisely. Our society has created vast amounts of wealth. This wealth has incredible powers for bringing out the best and worse in human beings. Those powers are difficult to fathom and equally as difficult to direct and control. Some of these issues are humorously depicted in the movie, "A New Leaf".[1]

A. Ignorance, Fear, Hopes and Desires - A nationwide survey study conducted by PNC Advisors and released in early 2005 questioned 792 affluent people including nearly 500 with more than $1 million in investable assets.[2] Among the surprising results were:

1. More than 37% of respondents lack a will or healthcare proxy and do not have a trust. The excuse cited by 56% of all respondents who do not have a will was procrastination. Twelve percent said they did not want to confront their own mortality and 5 % said they did not feel they had enough money to justify a will.

2. Almost half (49%) of survey respondents with children at home worry that their kids will grow up feeling "entitled" and nearly as many (44%) believe their children are spoiled. Nine out of ten respondents with children agree that it is important for children to learn the value of money through hard work and half (50%) said they do not believe kids today know the true value of a dollar.

   Of this same group only one third (29%) encourage their children to take after school jobs. The survey showed that 76% of respondents with children said it was important to be open with children on financial matters. Of that group only 58% have set up basic bank accounts for their children to use, only 29% have set up basic brokerage accounts for children to learn about investing and only 8% have set up a relationship with a financial advisor.

3. When asked how much they needed to feel financially secure in the future, respondents consistently cited a need to approximately double their current level of assets. Those with $10 million or more felt they needed a median of $18.1 million; those with $5 million or more needed $10.4 million; and those with a half million to $1 million said they needed $2.4 million.

4. Many of America's richest individuals are not communicating their plans, even with those closest to them. More than half (58%) of survey respondents have never discussed the transfer of wealth with family members, and one in five (23%) who have plans feel

[1] May, Elaine. (Director). (1971). *A New Leaf.* Paramount Studios 5555 Melrose Avenue, Hollywood, CA.
[2] PNC Advisors, Wealth and Values Survey, 2005.

no need to discuss them. More than one in 10 (14%) said they never even thought to have the discussion.

B. These polling results show the ignorance, fear, hopes and desires of many wealthy individuals. They want their children/heirs to grow up and live healthy, happy and productive lives. They recognize that wealth, if handled properly, can be a component in achieving these goals. Their fear centers on wealth's ability to corrupt and stifle initiative and block true happiness. Many wealthy individuals are uncomfortable with their money, don't plan properly, find it difficult to communicate with those who will inherit their wealth and worry about whether they themselves have enough to sustain their lifestyles.

C. The emotions surrounding wealth and the responsibility of finding the best way to pass it along to the next generation makes estate planning a daunting task. As in most things in life, there are no tried and true methods. Wealthy individuals often look to a trust as a vehicle by which they can attempt to protect or control their heirs "from the grave". They fear that the beneficiaries of their trust will be unable to handle the responsibilities and temptations of wealth. The grantors try to protect the beneficiaries from themselves.

D. This dark side of wealth, the source of worries and fears for those who hold it, looms large. Our society recognizes these worries and fears and has, in typical American entrepreneurial fashion, spawned an industry that attempts to aid the wealthy in addressing their concerns and helping the next generation live happy lives. The offerings range from books, websites, and periodicals to television shows and documentaries.

1. "Affluenza" is a term coined to describe the often dysfunctional relationship that people have with money and material things.[3]

2. The Public Broadcasting Service (PBS) has aired a program titled "Affluenza" describing this phenomenon. According to its web site "(t)hrough revealing personal stories, expert commentary, hilarious old film clips, dramatized vignettes, and "anti-commercial" breaks, "Affluenza" examines the high cost of achieving the most extravagant lifestyle the world has ever seen."[4]

3. More Than Money – an organization based in Cambridge, Massachusetts, that offers conferences, coaching, online discussion and a magazine geared to "... start participants on the path of

[3] The Affluenza Project. affluenza.com. 2005. Retrieved June 18, 2005 from http://www.affluenza.com.
[4] KCTS/Seattle and Oregon Public Broadcasting. Affluenza. Retrieved June 18, 2005 from www.pbs.org/kcts/affluenza/home.html.

becoming more efficient and clear decision-makers about their money and their values in order to create a more meaningful life."[5]

4. The Inheritance Project – an organization that "...explores the emotional and social impact of inherited wealth. The project's mission is fourfold: (1) To enhance our culture's understanding of the unique challenges and opportunities that inherited wealth brings (2) To help heirs break the isolation and overcome the taboos surrounding wealth (3) To show heirs how other inheritors have claimed their personal power and used it to benefit others (4) To provide networking and educational resources to heirs and professional advisors who work with them."[6]

5. "Born Rich"[7] a 2003 Sundance Film Festival Selection and Emmy-nominated documentary produced and directed by Jamie Johnson, an heir to the Johnson & Johnson fortune. The documentary examines wealth and its affect on children.

E. It is too easy to dismiss these and other organizations as crackpots or fly by night operations representing a passing fashion. Credentialed, established companies and individuals are recognizing that their clients take the heavy responsibilities of wealth seriously.

1. Resonate, Inc. is a financial and estate-planning firm based in Cincinnati, OH, which describes itself as having "...created an interactive planning process which first shifts the focus from your economic value to emphasizing your human value."[8].

2. Merrill Lynch's website contains an "Advice and Planning" article titled "Raising Wealthy Kids Right" which discusses "affluenza".[9]

3. Jon Gallo, J.D., senior partner in the estate-planning department of Greenberg, Glusker, Fields, Claman, Machtinger & Kinsella LLP in Los Angeles, CA and his wife psychotherapist Eileen Gallo, together founded the Gallo Institute. Their institute recognizes "...that people have complex relationships with family wealth and that affluence, handled properly, is a positive factor in one's life."

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[5] More Than Money. (2005). Retrieved June 18,2005 from www.morethanmoney.org/.
[6] The Inheritance Project. (2003). Inheritance-project.com. Retrieved June 18, 2005 from www.inheritance-project.com/.
[7] Johnson, Jamie. (Producer & Director). (2003). *Born Rich*. Home Box Office, Inc., a division of Time Warner Entertainment Company, 1100 Avenue of the Americas, New York, NY.
[8] Resonate, Inc.. Resonatecompanies.com. Retrieved June 18, 2005 from www.resonatecompanies.com/.
[9] C.J. Price. (Spring 2005). Raising Wealthy Kids Right. Reprinted from the Spring 2005 Issue of Merrill Lynch Advisor. Retrieved June 18, 2005 from Merrill Lynch, Pierce, Fenner & Smith website: http://askmerrill.ml.com/publish/marketing_centers/articles/aap_article_a018/.

Eileen Gallo is also author of the book "Silver Spoon Kids: How Successful Parents Raise Responsible Kids" [10]

4. PNC Advisors and its "Wealth and Values Survey",[11] as noted in Item I (a), above.

II. New ideas in dealing with wealth planning use a number of approaches to combat the negative issues associated with wealth. Among them are communication, education and building self-esteem.

A. Education - How can wealth be used to positively influence the lives of heirs?

1. Start the learning process when the heir is young and can be taught to handle money in a responsible way. For example, give children an allowance. Eileen Gallo, author of "Silver Spoon Kids: How Successful Parents Raise Responsible Kids" suggests that all children should get an allowance with no strings attached. The allowance should be a sharing of family resources, not as a form of compensation or as punishment. It is an excellent opportunity for teaching values and the uses of money.[12]

B. Communication – "Wealth is a subject everyone has traditionally been told not to talk about; it is a taboo" says Jamie Johnson, an heir to the Johnson & Johnson fortune. He goes on to say that "(i)f people are not willing to talk about the wealth they have created, and about how their children can be part of preserving the family business or the family wealth, you have confusion, and you run into a lot of problems. That is when you end up seeing the family company fail, or people losing their family fortune." [13]

C. Self-Esteem – This is a vital quality in any person. High self-esteem allows a person to function successfully in society. Low self-esteem can cripple an individual making them unable to navigate life successfully.[14] Those with low self-esteem have more financial problems than those with high self-esteem.

III. Discretionary Trusts

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[10] The Gallo Institute. (2005), Galloinstitute.com. Retrieved June 18, 2005 from www.galloinstitute.org/.
[11] Wealth and Values Survey. 2005. PNC Advisors.com. Retrieved June 18, 2005 from www.pncadvisors.com/pncadvisors/1,1264,522,00.html.
[12] Lowengard, Mary. Making Allowances for Youth. Worth. April 1, 2004. Retrieved June 18, 2005 from www.worth.com/Wealth/Family-Issues/Parenting-Making-Allowances-for-Youth.asp.
[13] Johnson, Jamie. Teach Your Children Well. Worth. July 1, 2004. Retrieved June 18, 2005 from www.worth.com/Wealth/Family-Issues/First-Person-Teach-Your-Children-Well.asp.
[14] *See* Hausner, Lee, (PhD). The Good Financial Parent. Worth, January 1, 2004, Retrieved June 18, 2005 from www.worth.com/Wealth/Family-Issues/Family-Matters-The-Good-Financial-Parent.asp.

A. Discretion – Black's Law Dictionary defines discretion as the "Wise conduct and management: cautious discernment; prudence"[15].

B. Discretionary Trust – A discretionary trust grants a trustee the power to distribute income and/or principal to or for a current or future beneficiary's benefit. The trust outlines the class or classes of beneficiaries who can receive these distributions, grants authority to the trustee to make distributions to some or all of them and provides guidelines to assist the trustee in determining the purposes for which the funds may be distributed and in what amounts.[16]

IV. Grantors need guidance in communicating their values and intentions and structuring discretionary language in such a way that furthers those values and intentions.

A. Educating grantors gives them a clear understanding of the impact of their decisions. It also allows them an opportunity to guide and instruct the beneficiaries. Grantors can be unaware of their ability to help or hurt the named beneficiaries. They may assume that the law dictates how a trust should read and that they are stuck with the "boilerplate".

B. Communication with family and financial advisors/trustee helps in dealing with the issues that will inevitably arise that the document's terms do not address.

1. A grantor engaging in an open discussion with beneficiaries about the terms of a trust can go a long way in easing tensions and helping everyone come to a mutual understanding of the wealth held by the trust and how the trust will make that wealth useful to its beneficiaries.

2. Ethical Wills – According to the Ethical Wills website, "Ethical wills are a way to share your values, blessings, life's lessons, hopes and dreams for the future, love, and forgiveness with your family, friends, and community. Ethical wills are not new. The Hebrew Bible first described ethical wills 3000 years ago (Genesis Ch. 49). References to this tradition are also found in the Christian Bible (John Ch. 15-18) and in other cultures....'Ethical wills' are not considered legal documents as compared to 'living wills' and your 'last will and testament' ...". [17]

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[15] Garner, Bryan A. (Ed). (2004). Black's Law Dictionary. St. Paul, MN: West Publishing Co.
[16] *See* Rounds, Charles E, Jr. (2005). Loring: A Trustee's Handbook. § 3.5.3.2(a). New York, NY: Aspen Publishers.
[17] Josaba Ltd. (1998) Ethicalwill.com. Retrieved June 18, 2005 from www.ethicalwill.com/.

3. Family Mission Statement – A statement best crafted by the whole family that outlines its philosophical basis and direction. This type of document can assist the grantor as well as the trustee and beneficiaries in understanding their common goals and beliefs. It can help clarify everyone's financial needs and aspirations.[18]

V. The Discretionary Trust – Drafting and Terms

A. See the outline prepared by Kelly Henry, co-presenter, which deals with this topic in detail.

B. Ideally, the drafting of discretionary language and standards should include input from the trustee. Discussion between the trustee, grantor and the drafter can result in language and standards that express the grantor's wishes in a clearer and more effective way. This collaborative process can also result in a trust that contains language which the beneficiaries can understand and use as a source of guidance.

1. For example, a trust permits payments to a beneficiary for "maintenance and support". This broad standard falls somewhere between the payment of a utility bill and a payment for a world cruise.[19] What is the grantor's intent? How would a trustee interpret this standard? How would the grantor feel about that interpretation? Does it foster good or negative behavior in the trust's beneficiaries?

VI. Working with Discretionary Distributions in Trusts

A. KY Law – Guidance for Trustees

1. The Kentucky Revised Statutes do not offer much in the way of guidance for a trustee in its handling of discretionary distributions of income or principal.

a. Under its "Definitions for Kentucky Principal and Income Act", the Kentucky Revised Statutes define "Terms of a trust" as "... the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct..."[20]. Under this definition, the obvious first place to look for guidance is the

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[18] Family Business Institute, Inc. (2004). Family-business-experts.com. Retrieved June 18, 2005 from www.family-business-experts.com/family-mission-statement.html.
[19] *See* Rounds, Charles E, Jr. (2005). Loring: A Trustee's Handbook. § 3.5.3.2(a). New York, NY: Aspen Publishers.
[20] Kentucky Revised Statues §386.450 (12) (2005).

text of the trust. Other written materials (ethical will, mission statement, etc. noted above) may also have a place under this definition. Spoken words and conduct also have their place, but are open to interpretation and problems of proof.

b. The Kentucky Revised Statutes §386.452(2) titled "Fiduciary duties" directs a fiduciary to "...administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest a contrary intention. [21] This is a reminder of the trustee's fiduciary duty to deal impartially with beneficiaries.

B. Fiduciary Duties – Trustees must adhere to numerous duties in administering a trust. Listed below for reference are all of the duties with notes accompanying those that have particular relevance in discretionary distributions.

1. Duty to administer the trust.

   a. When a trustee receives a request for a discretionary distribution it must be certain to review the document, be certain the request falls under the trust's terms and determine what standards apply.

2. Duty of loyalty.

3. Duty not to delegate.

4. Duty to keep and render accounts.

   a. The trustee must keep accurate records of discretionary distributions.

5. Duty to furnish information.

   a. Trustees have a duty "...to keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. Unless unreasonable under the circumstances, a trustee shall promptly respond to a beneficiary's request for information related to the administration of the trust."[22]

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[21] Kentucky Revised Statues §386.452 (2) (2005).
[22] Uniform Trust Code (2005) §813 (a).

6. Duty to exercise reasonable care and skill.
7. Duty to take and keep control.
8. Duty to preserve trust property.
9. Duty to enforce claims.
10. Duty to defend actions.
11. Duty to keep trust property separate.
12. Duty with respect to bank deposits.
13. Duty to make the trust property productive.
14. Duty to pay income to beneficiary.
15. Duty to deal impartially with beneficiaries.
    a. The Uniform Trust Code (UTC) "If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests."[23] In comments to this section, the UTC notes that "The duty to act impartially does not mean that the trustee must treat the beneficiaries equally. Rather, the trustee must treat the beneficiaries equitably in light of the purposes and terms of the trust. A settlor who prefers that the trustee, when making decisions, generally favor the interests of one beneficiary over those of others should provide appropriate guidance in the terms of the trust. *See* Restatement (Second) of § 183 cmt. a (1959)."[24]
16. Duty with respect to co-trustees.
    a. A trustee must confer with and obtain the permission of any co-trustee before a discretionary distribution is approved.
17. Duty with respect to person holding power of control.

[23] Uniform Trust Code (2005) §803.
[24] Uniform Trust Code (2005) §803, comment.

a. A trustee must confer with and obtain the permission of any advisor or other party who, by terms of the trust, must approve a discretionary distribution.

VII. The Practical – How to Deal with a Discretionary Distribution Request

A. Before A Request Is Received

1. Communication and Education – Ideally, when a trustee first accepts its appointment, a meeting should take place with all beneficiaries to discuss the trust's terms in some detail. Those individuals who will be dealing with the beneficiaries should be present. In the case of a bank trust company, this should include the investment and administrative officers. Topics such as the reasons why the trust was set up, the advantages it offers, the trust's assets and their management, and the processes involved in exercising its benefits should be among the items discussed. If the grantor is available, he or she should also attend so that they can explain the thinking behind the trust's provisions. Such a meeting will often bring out issues or confusion in a forum where they can be dealt with unencumbered by an actual discretionary distribution request and the emotion that can accompany it. The meeting is also an opportunity for the trustee or its representatives who will be working with those in attendance to establish some rapport and set the tone for how the trust will be administered. Written materials should be distributed to each participant including a copy of the trust and a summary of how the trust operates such as statement cycles, the timing of income distributions and the documentary requirements for a discretionary distribution request. A written summary of the meeting and its main points should also be sent to each participant after the meeting.

a. Beneficiaries who are not happy with their treatment under a trust document are seeking advice and resorting to legal action. Their discontent has spawned such organizations as Heirs, Inc., which describes itself as "…the first group of "unhappy" beneficiaries in the country dedicated to reforming the administration of trusts/estates."[25] There are also advocates for trust beneficiaries such as Robert Rikoon, CEO of Rikoon-Carret Investment Advisors and author of "Managing Family Trusts: Taking Control of Inherited Wealth".[26]

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[25] Heirs, Inc. (2005). *Heirs.net*. Retrieved June 19, 2005, from http://www.heirs.net/index.html.
[26] *See* Cotter, Marianne. The Business of Trust Busting. Worth. January 1, 2004. Retrieved June 18, 2005 from http://www.worth.com/Wealth/Trusts-Estates/Visions-Revisions-The-Business-of-Trust-Busting.asp.

b. It is too easy to term these organizations and advocates as crackpots and rabble-rousers. A review of some of their materials shows that there is clearly an underlying lack of beneficiary communication and education by grantors and trustees. There are also a number of clear issues created by trustees and their administration of trusts that could have been avoided.

B. Upon Receipt of a Request

1. Get the Request in Writing – Most often, a request for a discretionary distribution will come in the form of a telephone call from a beneficiary. If you are lucky, the request will be one that is not an emergency and can be dealt with in an expeditious and businesslike manner. Unfortunately, many requests arrive as "emergencies" that the caller expects will receive immediate attention. Regardless as to how these requests are received, the trustee's representative must insist that the request be submitted in writing by the requestor. In today's world of e-mail, (which is an acceptable form for the written request), this is a less onerous requirement than it once was. Written requests are an absolute necessity for the trustee, especially in the case of bank trustees who are subject to reviews by compliance authorities of every stripe who insist on having a written request in file.

2. Review the Trust Document – The trustee has a fiduciary duty to administer a trust by its terms. It is important to read the trust document in order to determine the circumstances under which a discretionary distribution can be made and the standards that are applicable. While this is a very basic step, it may be one that during a busy period is easily set aside because "I know that document". A review of the applicable state law should also occur in conjunction with a reading of the trust.[27]

3. Obtain and Review Supporting Documentation

    a. Document the Expense - While each request for a discretionary distribution is different, most will involve the payment of some type of expense that can be documented by way of an invoice or bill. As with the need for a written request, the trustee needs this item for reasons of documentation and, in the case of bank trustees, compliance.

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[27] *See* Hahn, C., Stalions, S. & Staser, J., (2002) "Considerations in Reviewing Requests for Discretionary Trust Distributions." Hoosier Banker.

b. Other Resources – A trustee should also give consideration to the other resources available to the requestor that could be put to use in addressing the issue that has triggered his or her distribution request. The trust itself will often have terms that specifically require the trustee to investigate other assets or ignore their existence. Where this issue is specifically addressed one way or the other, the trustee has clear cut direction as to how it should proceed.

   i. The Restatement Trusts third edition gives the following guidance:

      > A trustee may have discretion, and perhaps a duty, to take account of the principal of the beneficiary's personal estate, depending on the terms and purposes of the discretionary power and other purposes of the trust. The settlor's relationships and objectives with respect to both the beneficiary in question and the trust's other current and remainder beneficiaries are of particular relevance. Also important are any income, estate, and other tax purposes the trust may serve (see Comment g) as well as the liquidity (including marketability and income-tax basis) of the discretionary beneficiary's assets.[28]

   ii. Where the document is silent on the issue of other resources, the trustee has a quandary. Statutory and case law is non-existent on this issue in Kentucky as it is in most jurisdictions.[29] From a practical standpoint, if the trustee finds the trust is silent on this issue it should, from the outset, attempt to make it standard practice that a discretionary distribution request be accompanied by copies of income tax returns, financials statements, budgets or some other

[28] Restatement (Third) of Trusts §50, cmt. E(2).

[29] *See* Rounds, Charles E, Jr. (2005). Loring: A Trustee's Handbook. § 3.5.3.2(a). New York, NY: Aspen Publishers.

documentation which shows the requestor's financial status.

4. Other Beneficiaries – If there are a number of other beneficiaries who could potentially request distributions from the trust, the trustee must determine the impact of the current request on their ability to have their own future requests granted. A trustee may be aware of their current or potential needs and should weigh how those needs might be impacted. As noted above, a fiduciary's duty of impartiality requires the trustee to treat all of the beneficiaries fairly given the trust's stated terms and purposes.[30]

5. Prior History of Distributions – A trustee should review the trust's prior history of distributions as part of the discretionary distribution process. Does the beneficiary have a history of requests that are abusive in nature? Is there a pattern emerging that the trustee can address by some other means? Is there a pattern of distributions to other beneficiaries that could be disrupted by the granting of the current request?

6. Review of the Trust Assets and Cash Position – This is normally a rather basic step in the process of considering a discretionary distribution request. However, where the request is large and the trust assets small, it could be a very important consideration. In addition, the number of other beneficiaries who could potentially request distributions could make an otherwise routine request one that must be given a great deal of consideration.

7. Consult with Co-Trustees, Advisors or other Co-Fiduciaries – The trustee receiving a discretionary distribution request must be sure to share the request with any co-fiduciary whose authorization must also be obtained before it is granted or denied. It is also necessary to keep investment advisors or others who have authority over investment decisions apprised of discretionary distributions that may require investment action.

[30] *See* Uniform Trust Code (2005) §813 (a).

DRAFTING FOR AND MAKING DISCRETIONARY DECISIONS AND DISTRIBUTIONS

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DRAFTING FOR AND MAKING DISCRETIONARY DECISIONS AND DISTRIBUTIONS

I. Absolute Discretion v. Standards for Distribution

In establishing any discretionary trust, that is, a trust in which payments of either income or principal or both are not specifically dictated by the terms of the trust instrument, one of the first decisions that a grantor must make—after naming the trustee, of course—is whether such distributions are to made at the discretion of the trustee or in accordance with certain standards that the trustee must follow.

A. Absolute Discretion

In trusts which grant the trustee absolute discretion over distributions of income and principal, the trust beneficiary is only entitled to the amount that the trustee in the proper exercise of its discretion decides is appropriate for the beneficiary[1]. A beneficiary who disagrees with a trustee's decision cannot request the court to compel the trustee to make a distribution to the beneficiary unless the trustee has abused its discretionary power.[2]

> 7.2 Trustee will distribute from the net income and principal of the trust such amounts as Trustee in its sole and absolute discretion deems advisable to my child and my child's descendants. Undistributed income will be added to principal. Unequal distributions will not be taken into account in the final distribution of assets. Trustee's decision will be controlling and will not be subject to judicial review.

B. Standards for Distribution

In trusts which establish standards for the distributions of income and principal, the trust beneficiary is only entitled to the amount that the trustee in the proper exercise of its discretion decides is appropriate for the beneficiary to satisfy those standards[3]. A beneficiary who disagrees with a trustee's decision may request the court to compel the trustee to make a distribution to the beneficiary but the court will not compel the trustee to do so unless its decision was not reasonable.[4]

The most common standards are for health, education, maintenance and support.

> 7.2 Trustee will distribute from the net income and principal of the trust such amounts as Trustee deems advisable to provide for the health, education (including education beyond the

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[1] Scott on Trusts, § 128.3.

[2] Id.

[3] Scott on Trusts, § 128.4.

[4] Id.

> undergraduate level), maintenance, and support of my child and my child's descendants. Undistributed income will be added to principal. Unequal distributions will not be taken into account in the final distribution of assets.

These standards are often further limited by requiring the trustee to take into account a beneficiary's accustomed standard of living or by taking into account income and other assets available to the beneficiary from other sources.

Observation: The preference among corporate trustees in the northeastern United States tends to be absolute discretion trusts. The preference among corporate trustees in the South and Mid-West tends to be trusts with standards for support. The jury is still out on the West Coast.

C. Ascertainable Standards and I.R.C. § 2041

The most common standards for distributions found in discretionary trusts are those of health, education, maintenance and support. These are often referred to as "ascertainable standards" because of their interplay with section 2041 of the Internal Revenue Code of 1986, as amended (the "Code").

Treasury Regulation § 20.2041-1 provides that an individual will be deemed to have a power of appointment over the assets of a trust, thereby causing such assets to be included in his or her estate for federal estate tax purposes, if the individual has the power to consume or appropriate the principal of the trust.[5] This can occur if the beneficiary is serving as the trustee and has absolute discretion over the distribution of the trust assets or if the beneficiary has the power to remove the trustee and appoint himself as the trustee.[6]

However, if the beneficiary is serving as the trustee and the trustee's ability to encroach on trust principal is limited to "ascertainable standards", the trust assets will not be included in the beneficiary's estate. According to the Treasury Department, "ascertainable standards" are limited to health, education, maintenance and support.

> *(2) Powers limited by an ascertainable standard.* A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs

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[5] Treas. Reg. § 20.2041-1(b)(1).

[6] Id.

> for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

Treas. Reg. § 20.2041-1(c)(2).

Note that section 2041 does not prevent the grantor from establishing a purely discretionary trust. However, in order that the trust assets are not included in the beneficiary's estate, the trustee at all times must be an independent trustee, i.e., a corporate trustee, or an individual whose interests are adverse to those of the beneficiary.

D. Medicaid Trusts

In certain situations, establishing a trust with ascertainable standards may not be an option. Typically this arises in the context of asset protection trusts and trusts which are designed so that the beneficiary will qualify for public assistance. In the latter, although the Trustee must be given sole and absolute discretion regarding distributions for the beneficiary's needs, it is still important that the grantor specify his or her intent regarding distributions for extraordinary needs that are not covered by Medicaid and Social Security.

> 7.2 My child suffers from disabilities which substantially impair my child's ability to provide for my child's own care and custody and which constitute a substantial handicap. It is my intent in establishing this trust that it facilitate my child's financial eligibility for Supplemental Security Income (SSI) and Medicaid under the provisions of Section 13611 of the Omnibus Budget Reconciliation Act of 1993 (42 U.S.C. s. 1396p(d)(4)(a)) and Section 205 of the Foster Care Independence Act of 1999 (42 U.S.C. s. 1382(b)), and other applicable provisions of state and federal law. It is important that my child continue to have, or to be able to apply for, these programs in order to maintain a level of human dignity and humane care. If this trust were to be invaded by creditors, subjected to any liens or encumbrances, or cause public benefits to be terminated, it is likely that the trust principal would be depleted prior to my child's death, especially considering

the substantial expense of providing care and services for a disabled person. In this event, there would be no supplemental fund for emergencies, necessary programs, and my child's care. The following trust provisions should be interpreted in light of these concerns and the stated intent.

A. Trustee may pay to or apply for my child's benefit such amounts from the income or principal, up to the whole thereof, as Trustee may, in Trustee's sole discretion, from time to time, deem necessary or advisable for the satisfaction of my child's special needs. The following are examples of what Trustee might consider to be my child's special needs: dental expenses, special equipment, programs of training, education and treatment, occupational and physical therapy not provided by Medicaid or any other program of public benefits, assisted mobility equipment, assisted communications equipment, transportation, acquisition of a wheelchair-accessible van, attendant care, modifications to the family home for my child's care, and necessary recreation and entertainment.

B. Except as otherwise expressly provided herein, no interest in the income or principal of this trust may be anticipated, assigned or encumbered, or be subject to any creditor's claim or to legal process, prior to its actual receipt by my child. Furthermore, because this trust is to be conserved and maintained for my child's special needs, no part of the principal or income will be construed as part of my child's "estate" or be subject to the claims of voluntary or involuntary creditors for the provision of care and services, including residential care, by any city, county, or state government, or by the federal government or any other public or private agency.

C. Trustee is not responsible for seeking support and maintenance for my child from available public resources. However, in making distributions to or for my child's special needs as herein defined, Trustee will take into consideration the applicable resource and income limitations of the means-tested public benefit programs for which my child is eligible, including SSI and Medicaid.

D. The assets of this trust will be administered (1) in a manner that supplements means-tested public benefits, and (2) if feasible, trust distributions should not be made that cause the loss or reduction of such benefits. However, the ultimate goal of this trust is to ensure my child's good health, safety and welfare. Consequently, Trustee will suffer no liability of any kind if Trustee makes a distribution that causes the loss or reduction of benefits if

Trustee determines, in Trustee's absolute discretion, that such distribution is in my child's best interests. It is recommended that neither means-tested public benefits nor my child's earnings be added to the trust estate unless Trustee determines that it is in my child's best interests to do so; provided, however, that if such assets are so added, they will not be commingled with other trust assets but will be separately held by Trustee in order to preserve applicable creditor protections.

II. Who is the Primary Beneficiary?

When creating trusts that currently benefit multiple generations, it is in everyone's best interests that the grantor indicate whether the trustee is to give any priority or preference to certain individuals or a class of individuals or if all beneficiaries are on equal footing. This is of particular concern for trustees in administering a "family trust" or "credit shelter trust" in light of the increasing applicable exemption amount. This is further complicated in second and third marriages when the grantor's spouse is not the parent of the grantor's descendants.

ARTICLE 5B
Administration of Fund B for the Benefit of
<u>My Spouse and Descendants</u>

[Choose one of the following statements regarding preference among beneficiaries]

Trustee will consider a beneficiary's income and assets, and tax consequences (direct and indirect), when making distributions. I have made my descendants beneficiaries of Fund B to provide for reasonable flexibility, but my Spouse is the primary beneficiary.

Trustee will consider a beneficiary's income and assets, and tax consequences (direct and indirect), when making distributions. Although I intend for my Spouse to continue to live in the style to which my Spouse is accustomed, and generally want my Spouse treated generously, I also intend for amounts to be available for my descendants during and after my Spouse's life.

Trustee will consider a beneficiary's income and assets, and tax consequences (direct and indirect), when making distributions. I intend for my descendants to be the primary beneficiaries of Fund B to the extent consistent with maintaining a reserve to satisfy my Spouse's basic needs if my Spouse's other assets are substantially exhausted and my Spouse's income is insufficient.

Likewise, in trusts for the benefit of the grantor's descendants, the grantor should indicate whether preference should be given to children over grandchildren to avoid conflicts in the future.

> 6.3 In the trusts that follow, when Trustee is given the discretion to make distributions among my beneficiaries, primary consideration will be given to those beneficiaries in the oldest generation, but their taxable estates will be considered when making such distributions.

III. Power of Withdrawal and Advancements

It is not unusual for disagreements or disputes to arise among beneficiaries in even the most harmonious of families when it comes to encroachments on principal. One sibling may be more prosperous than another, one sibling may be more frugal than another, one sibling may have more children than another, and more often than not, everyone has different investment objectives. Also, if mom or dad is also a beneficiary of the trust, he or she may not want to justify to the children why the trustee should make a distribution for a new roof for the house, a new car, or even a well deserved vacation.

One way to resolve this issue is by giving the trust beneficiaries, or certain trust beneficiaries, a power of withdrawal. The beneficiary is entitled to withdraw a certain amount from the trust each year and to spend that amount as he or she chooses, no questions asked.

> 5B.2 My Spouse may, each year my Spouse is living on December 31, by written notice to Trustee, withdraw specific assets from the principal of Fund B, the value of which does not exceed 5% of the market value of the principal of Fund B on December 31 of the year of withdrawal. This right to withdraw is noncumulative. Trustee may make reasonable advancements to my Spouse in anticipation that my Spouse will be living on December 31, provided such advancements are repayable to Trustee if my Spouse dies before December 31. Regardless of other provisions to the contrary my Spouse, or an agent acting on behalf of my Spouse, may relinquish this right at any time by written notice to Trustee.

Another possible solution is through the use of advancements. The trustee may make distributions of principal for extraordinary expenditures that will ultimately be charged against that beneficiary's share when the trust is later divided.

> 7.3 After my child becomes 21 years old, Trustee, at Trustee's discretion, may advance an amount from a trust having the child as a then current beneficiary to enable such child to enter into a trade, business or profession, or to purchase a principal

residence and (regardless of other provisions to the contrary) such amount will be charged as an advancement without interest to such child in the final distribution of assets. Trustee, however, will not be liable if, for any reason, such advancement exceeds the child's final distributable share of the trust property. No such advancement may be made if to do such would impair a beneficiary's withdrawal rights.

IV. Flexibility Through Powers of Appointment

More and more today, grantors are creating trusts that last for the lifetime of their descendants instead of terminating at certain ages. There are both tax and non-tax reasons for doing so. The most common tax advantage of lifetime trusts is postponing the time in which the assets will be subject to the federal estate and/or generation-skipping transfer taxes again. The non-tax advantages of lifetime trusts include creditor protection including protection from in-laws and other predators.

The disadvantage of trusts of such long duration is that circumstances may change and provisions that once worked flawlessly may become rigid and archaic. To prevent this and to provide flexibility for the future, it is often recommended that the grantor give special powers of appointment to the trust beneficiaries to be able to change or terminate the trust after their deaths.

For those individuals who want the trust assets to remain in the family at all costs, they may choose to grant a special power of appointment[7] that is limited to their descendants.

> 7.3 My child may appoint, by specific reference to this power in my child's Will, part or all of the assets of this trust among my descendants; or if none, to any person or entity (but in all instances excluding such child, such child's estate, such child's creditors, and the creditors of such child's estate) in such proportions and in such manner, outright or in trust or otherwise, as my child determines. Regardless of other provisions to the contrary, my child may relinquish this power in whole or in part at any time by written notice to Trustee. Assets not disposed of by a power of appointment will be known as the remaining trust assets.

On the other hand, many individuals choose may not want to limit the power to just their descendants because: (1) they actually like their sons- and daughters-in-law; (2) they have children who do not have children of their own; (3) they would like for their children to be able

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[7] A special power of appointment will not cause the trust assets to be included in the beneficiary's estate under section 2041 of the Code. Section 2041 only applies to general powers of appointment which include the ability to appoint to one's self, one's estate, one's creditor, and the creditors of one's estate. Treas. Reg. § 20.2041-1(c).

to leave money to charity; or (4) they were going to give their assets outright to their descendants until their estate planning attorney or trust officer talked them into creating a trust. For these individuals, granting a broad special power of appointment is more appropriate.

> 7.3 My child may appoint, by specific reference to this power in my child's Will, part or all of the assets of this trust among any person or entity (but in all instances excluding such child, such child's estate, such child's creditors, and the creditors of such child's estate) in such proportions and in such manner, outright or in trust or otherwise, as my child determines. Regardless of other provisions to the contrary, my child may relinquish this power in whole or in part, at any time by written notice to Trustee. Assets not disposed of by a power of appointment will be known as the remaining trust assets.

However, even in first marriages, more often than not, the grantor will not want to give his or her surviving spouse a broad special power of appointment. Although the grantor may want his or her surviving spouse to be able to appoint the assets freely among the grantor's descendants, generally, the grantor does not want the surviving spouse to be able to appoint those assets away from the grantor's descendants, usually to the survivor's widow(er). In second or third marriages, the grantor may not want to give his or her spouse any power of appointment.

V. Use of an Advisory Committee for Unique or Difficult to Manage Assets

Often a grantor will own assets that are unique or somewhat difficult to manage and which may require special expertise that is beyond the trustee's experience. Such assets include real estate, closely held business interests, artwork and intellectual property. In such instances it is may be advantageous to the beneficiaries of the trust that the grantor create an advisory committee to direct the trustee regarding the investment of these assets so that their income potential and value are properly exploited. It is also in the trustee's interest that the grantor creates an advisory committee because KRS 287.275 limits a corporate trustee's liability for certain investment decisions when following the direction of an advisory committee.

> ARTICLE 11
> Advisory Committee
>
> 11.1 During any time I am incapacitated or after my death, TOM, DICK, and HARRY are appointed as the initial Advisory Committee ("Advisor") to Trustee. No Advisor will be deemed to have accepted such position until the Advisor gives written notice of acceptance to the then acting Trustee. Notwithstanding anything herein to the contrary, Trustee will be subject to the powers and authority of Advisor as hereinafter set forth.

A. Powers. Advisor has the following powers and authority:

(A.1) To advise Trustee, to approve or disapprove any investment recommendation made by Trustee, to direct Trustee with respect to general investment policy, to initiate action, and to direct Trustee concerning important matters pertaining to all closely held business investments of any trust established hereunder, including, but not limited to, the borrowing of money, the lease, sale, investment, and reinvestment of any trust assets, the making of tax elections applicable to a trust, and the voting of stock.

The grantor may also want to give the advisory committee the power to direct the trustee regarding discretionary distributions of income and principal, especially if there are minor beneficiaries, in second and third marriage situations, or if there are other circumstances in which conflicts are likely to arise in the family.

(A.2) To approve, disapprove, or direct discretionary payments or accumulations of income or encroachments upon the principal of any trust established hereunder, subject to the standards herein set forth.

VI. Distributions to Minors or Incapacitated Beneficiaries

It is not uncommon when there are minor or incapacitated beneficiaries that the beneficiary's guardian and the trustee are different people. As a result, the trustee may have reservations of making distributions to a beneficiary if such distributions could potentially benefit the beneficiary's guardian. This concern can be addressed easily in the trust instrument.

12.1 After my death, Trustee may make distributions to or on behalf of a beneficiary even though such distributions benefit a guardian or the person having custody of the beneficiary if such benefit is reasonable under the circumstances.

However, the grantor may want to take additional steps to ensure that his or her intentions with respect to his or her minor children are understood clearly by the trustee. One method of accomplishing this is through a letter from the grantor to the trustee setting out the grantor's specific intentions.

July 21, 2005

Ms. Trust Officer
Senior Vice President
Worthy National Bank of Kentucky

100 West Main Street, Suite 200
Louisville, Kentucky 40202
Dear Trustee:

You are the Trustee of my Revocable Trust Agreement dated July 21, 2005. Paragraph 12.1 of this trust provides that you may make distributions to or on behalf of my child even though such distributions may benefit a guardian or the person having custody of my child. It is my intention and desire that this paragraph be interpreted liberally, such that distributions be made which will enhance the quality of my child's life.

If a guardian is ever required, I want the guardian to be able to nurture his or her relationship with my child so that the relationship resembles a parent-child relationship as closely as possible. For example, I wish for the guardian and my child to take family vacations together and I would like the guardian to visit my child while he or she is away at school, just as I would do if I were able. To this end, I am not concerned that distributions made to enable the guardian to do these and similar activities will benefit the guardian.

Cordially,

Kelly S. Henry

VII. Incentive Trusts to Influence Behavior

The goal of many affluent individuals today when creating trusts for their families is to try to impart their values and work ethic on future generations. As a result, for many individuals incentive trusts are an attractive option.

Incentive trusts may be used to encourage certain behaviors and to discourage others. Among the behaviors that most clients want to encourage are education, industry, public service and philanthropy. The behaviors that most want to discourage include reckless consumption, sloth and self-destructive behavior such as drug and alcohol abuse.[8]

Provisions that award a beneficiary upon the completion of a certain goal set by the grantor, such as graduating from college, are fairly simple to draft and to administer.

[8] Howard M. McCue, III, "Planning to Influence Behavior," 2000 University of Miami Heckerling Institute on Estate Planning, 6-1, 6-7 to 6-10 (2000).

7.3 Trustee will distribute $25,000 to my child if my child receives a bachelor's degree from an accredited college or university.

Provisions designed to discourage behaviors such as drug and alcohol abuse are more complicated. For example, the following language is designed to prevent drug and alcohol abuse by beneficiaries. This language is not perfect and typically, would only be included in the trust instrument if the grantor was aware of an existing problem with one of the beneficiaries at the time the trust was created.

ARTICLE 10
<u>Periodic Testing</u>

10.1 It is my belief that the purposes of wealth are to enable people to better themselves, their families, and the communities in which they live. I also believe that wealth should not be used to encourage or enable one to be a wastrel or a profligate which could lead to self destruction, the deterioration of one's family, and a blot on one's community. For these reasons, I authorize Trustee to establish a program which will result in the income beneficiaries, age 18 and over, of the trusts administered by Articles 4 and 5 to be subjected to random testing for alcohol and other drug abuse.

10.2 Income and principal distributions (1) to those who test positive, (2) to those who refuse to cooperate in the testing process, or (3) to those who have incurred morbidity due to drug or alcohol abuse, will not be made pursuant to the standards set forth in paragraphs 4.2 and 5.2, but will be made in the sole discretion of Trustee.

10.3 If, and when, subsequent testing (given within one year after an event described in paragraph 10.2) reveals a negative result, the beneficiary who once tested positive, or who refused to cooperate in an earlier testing process, will again be eligible to receive income and principal distributions as set forth in paragraphs 4.2 and 5.2, as the case may be.

10.4 The costs incurred in tests conducted by the provisions of this Article will be paid from the principal of the trust for which the person being tested is a beneficiary.

10.5 I realize that most drugs are water soluble and pass through the body in a short time -- certainly prior to the time the beneficiary is given reasonable notice for a test date. Thus, I am aware that the provisions of this Article are flawed; perhaps never detecting alcohol abuse.

10.6 I give Trustee powers, exercisable in Trustee's sole discretion, to direct the trust beneficiary to be subjected to additional testing, by a medical doctor, or doctors, selected by Trustee. The failure of a beneficiary to be tested or the finding that the beneficiary has incurred morbidity due to alcohol or drug abuse, constitutes authority to Trustee to pay income and principal to the beneficiary at the sole discretion of Trustee.

10.7 Trustee's decisions in implementing (or not implementing) the provisions of this Article will be final and will not be subject to judicial review. Trustee will incur no liability for its decisions made hereunder. Any expense incurred by Trustee in carrying out the provisions of this Article, including the defense of any law suits brought against Trustee, will be paid from the principal of the trust involved.

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TOTAL RETURN TRUST CONVERSION

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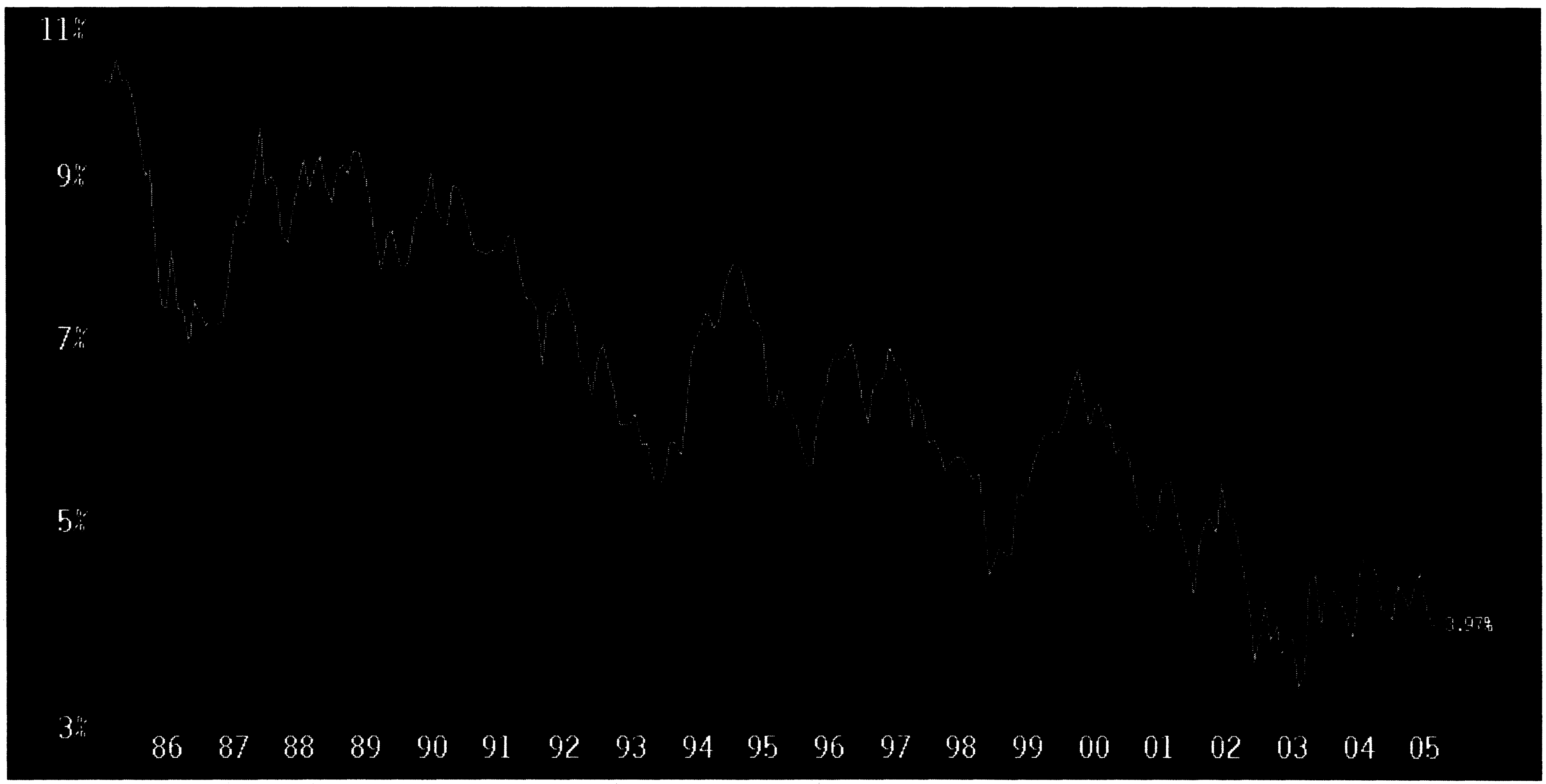
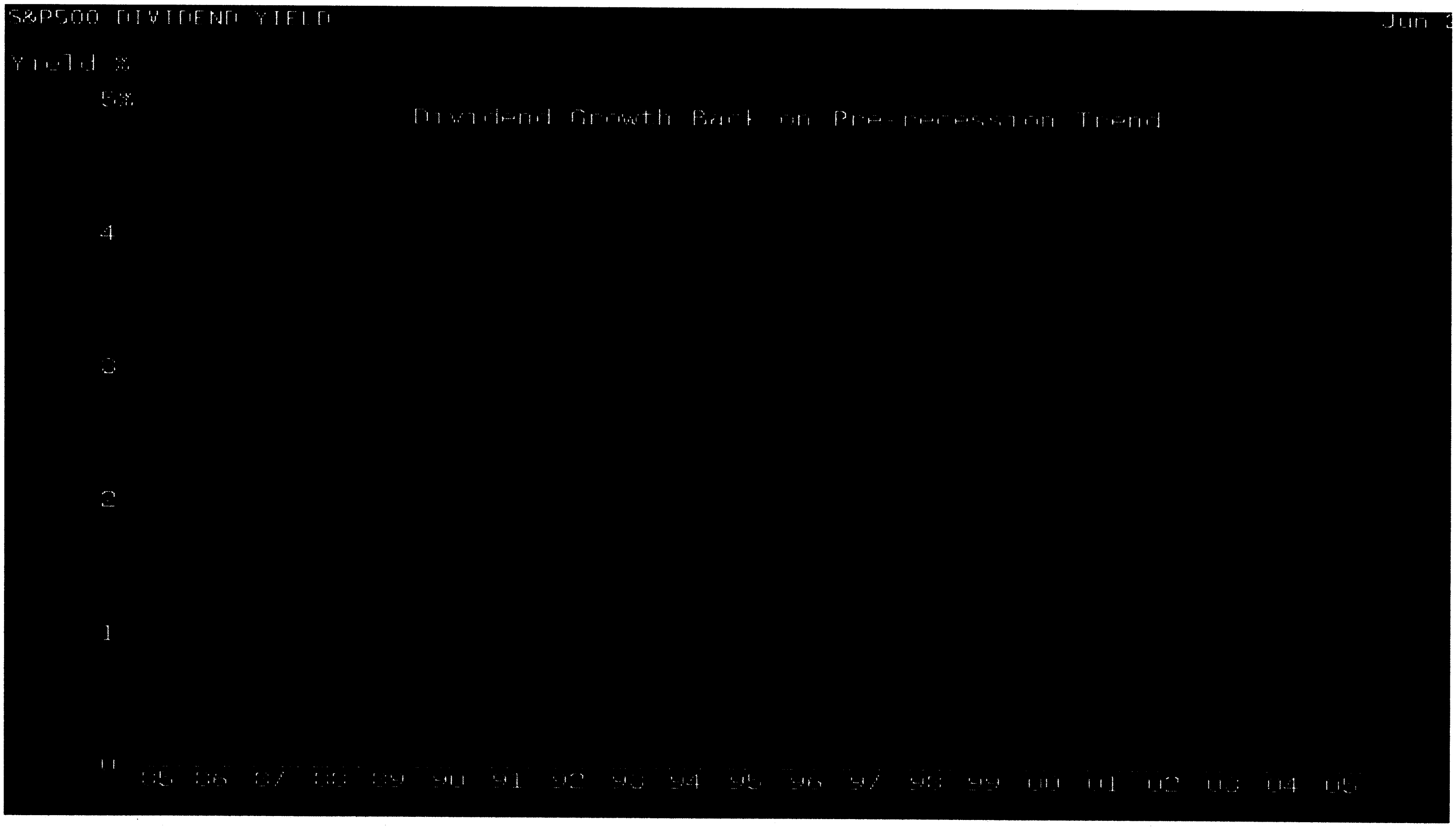
SECTION C

TOTAL RETURN TRUST CONVERSION

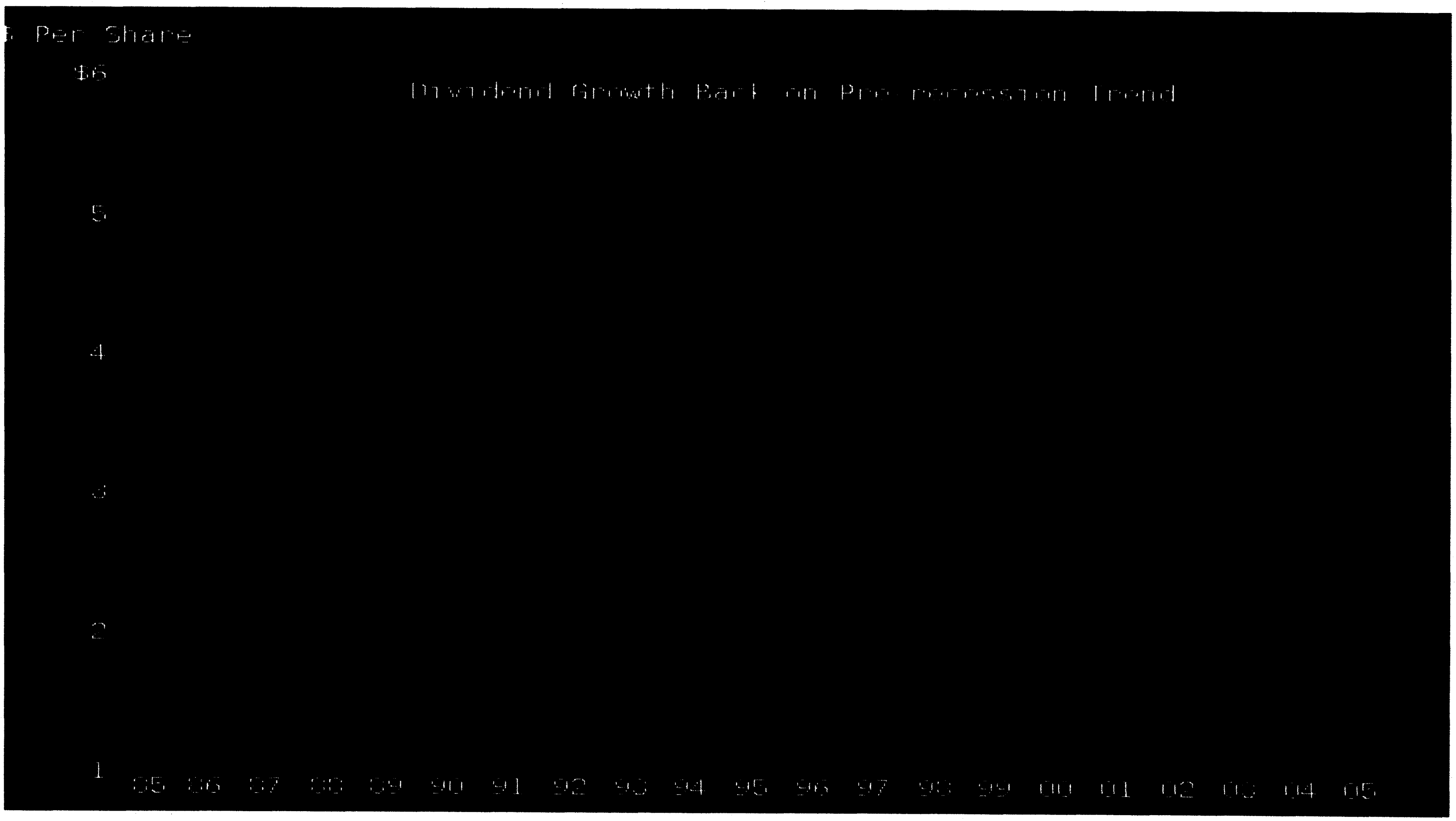
10 year Treasury Yields



S&P 500 dividend yield



S&P 500 dividends



Stocks can provide more income

Stock example: 2.0% initial yield (increases by 9% per year)

Year	Annual Dividend Income	Yield On Cost (YOC)	Gross income	Net of 38.6% tax	Net of 15% tax	Annual Interest Income	Cumulative Income
1	2,000.0	2.0%	2,000.0	1,228.0	1,700.0	$4,000	$4,000
2	2,180.0	2.2%	4,180.0	2,566.5	3,553.0	4,000	8,000
3	2,376.2	2.4%	6,556.2	4,025.5	5,572.8	4,000	12,000
4	2,590.1	2.6%	9,146.3	5,615.8	7,774.3	4,000	16,000
5	2,823.2	2.8%	11,969.4	7,349.2	10,174.0	4,000	20,000
10	4,343.8	4.3%	30,385.9	18,656.9	25,828.0	4,000	40,000
15	6,683.5	6.7%	58,721.8	36,055.2	49,913.6	4,000	60,000
20	10,283.3	10.3%	102,320.2	62,824.6	86,972.2	4,000	80,000
25	15,822.2	15.8%	169,401.8	104,012.7	143,991.5	4,000	100,000

Stock example: 3.0% initial yield (increases by 7% per year) — Bond example: 4.0% coupon

Year	Annual Dividend Income	Yield On Cost (YOC)	Gross income	Net of 38.6% tax	Net of 15% tax	Annual Interest Income	Cumulative Income
1	$3,000	3.0%	$3,000	$1,842	$2,550	$4,000	4,000
2	3,210	3.2%	6,210	3,813	5,279	4,000	8,000
3	3,435	3.4%	9,645	5,922	8,198	4,000	12,000
4	3,675	3.7%	13,320	8,178	11,322	4,000	16,000
5	3,932	3.9%	17,252	10,593	14,664	4,000	20,000
10	5,515	5.5%	41,449	25,450	35,232	4,000	40,000
15	7,736	7.7%	75,387	46,288	64,079	4,000	60,000
20	10,850	10.8%	122,986	75,514	104,539	4,000	80,000
25	15,217	15.2%	189,747	116,505	161,285	4,000	100,000

	CLIENT		Smith Family income only							
	Beginning Value		$5,000,000		% Allocation - Stocks		50			
	Yield on Stocks		2.00		% Allocation - Bonds		50			
	Yield on Bonds		4.00		Cap. Gains Tax rate %		21			
	Interest income is tax exempt				Turnover Rate, Stocks %		25			
	Growth Rate of Stocks		6.00		Payout Rate to Benes %		0			
	Beginning Year		2005		TWU fee 6.0% of income, 0.3% of principal					
	Income bene pays income fee				Principal fee paid by trust					

Year	Calendar Year	Beginning Value	Interest Income	Dividend Income	Gross Income	Tax owed on Dividends	Net Income After Trust Fee and Divd tax	Capital Gain Realized During Year	Capital Gains Taxes Payable By Trust	Principal Mgmt Fee
0	2005	5,000,000	100,000	50,000	150,000	10,500	141,000	37,500	7,875	15,000
1	2006	5,127,125	102,543	51,271	153,814	10,767	134,085	38,453	8,075	15,381
2	2007	5,257,482	105,150	52,575	157,724	11,041	137,494	39,431	8,281	15,772
3	2008	5,391,154	107,823	53,912	161,735	11,321	140,990	40,434	8,491	16,173
4	2009	5,528,224	110,564	55,282	165,847	11,609	144,574	41,462	8,707	16,585
5	2010	5,668,779	113,376	56,688	170,063	11,904	148,250	42,516	8,928	17,006
6	2011	5,812,908	116,258	58,129	174,387	12,207	152,020	43,597	9,155	17,439
7	2012	5,960,701	119,214	59,607	178,821	12,517	155,885	44,705	9,388	17,882
8	2013	6,112,251	122,245	61,123	183,368	12,836	159,848	45,842	9,627	18,337
9	2014	6,267,655	125,353	62,677	188,030	13,162	163,912	47,007	9,872	18,803
10	2015	6,427,011	128,540	64,270	192,810	13,497	168,080	48,203	10,123	19,281
15	2020	7,286,660	145,733	72,867	218,600	15,302	190,561	54,650	11,476	21,860
20	2025	8,261,293	165,226	82,613	247,839	17,349	216,050	61,960	13,012	24,784
25	2030	9,366,289	187,326	93,663	280,989	19,669	244,948	70,247	14,752	28,099
30	2035	10,619,084	212,382	106,191	318,573	22,300	277,711	79,643	16,725	31,857
35	2040	12,039,447	240,789	120,394	361,183	25,283	314,856	90,296	18,962	36,118
40	2045	13,649,793	272,996	136,498	409,494	28,665	356,970	102,373	21,498	40,949
	Cumulative						9,264,358			

CLIENT		Smith Family income only							
Beginning Value		5000000		% Allocation - Stocks		60			
Yield on Stocks		2		% Allocation - Bonds		40			
Yield on Bonds		4		Cap. Gains Taxrate		21			
Interest income is tax exempt				Turnover Rate, Stocks		25			
Growth Rate of Stocks		6		Payout Rate to Beneficiar		0			
Beginning Year		2005		TWU fee 6.0% of income, 0.3% of principal					
Income bene pays income fee				Principal fee paid by trust					

Year	Calendar Year	Beginning Value	Interest Income	Dividend Income	Gross Income	Tax owed on Dividends	Net Income After Trust Fee and Divd tax	Capital Gain Realized During Year	Capital Gains Taxes Payable By Trust	Principal Mgmt Fee
0	2005	5,000,000	80,000	60,000	140,000	12,600	131,600	45,000	9,450	15,000
1	2006	5,155,550	82,489	61,867	144,355	12,992	123,094	46,400	9,744	15,467
2	2007	5,315,939	85,055	63,791	148,846	13,396	126,924	47,843	10,047	15,948
3	2008	5,481,318	87,701	65,776	153,477	13,813	130,872	49,332	10,360	16,444
4	2009	5,651,842	90,429	67,822	158,252	14,243	134,944	50,867	10,682	16,956
5	2010	5,827,671	93,243	69,932	163,175	14,686	139,142	52,449	11,014	17,483
6	2011	6,008,969	96,144	72,108	168,251	15,143	143,470	54,081	11,357	18,027
7	2012	6,195,909	99,135	74,351	173,485	15,614	147,934	55,763	11,710	18,588
8	2013	6,388,663	102,219	76,664	178,883	16,099	152,536	57,498	12,075	19,166
9	2014	6,587,415	105,399	79,049	184,448	16,600	157,281	59,287	12,450	19,762
10	2015	6,792,349	108,678	81,508	190,186	17,117	162,174	61,131	12,838	20,377
15	2020	7,916,715	126,667	95,001	221,668	19,950	189,020	71,250	14,963	23,750
20	2025	9,227,201	147,635	110,726	258,362	23,253	220,309	83,045	17,439	27,682
25	2030	10,754,618	172,074	129,055	301,129	27,102	256,778	96,792	20,326	32,264
30	2035	12,534,874	200,558	150,418	350,976	31,588	299,283	112,814	23,691	37,605
35	2040	14,609,823	233,757	175,318	409,075	36,817	348,825	131,488	27,613	43,829
40	2045	17,028,248	272,452	204,339	476,791	42,911	406,567	153,254	32,183	51,085
	Cumulative						9,650,122			

	CLIENT		Smith Family income only							
	Beginning Value		5000000		% Allocation - Stocks		60			
	Yield on Stocks		2		% Allocation - Bonds		40			
	Yield on Bonds		4		Cap. Gains Tax rate		21			
	Interest income is tax exempt				Turnover Rate, Stocks		25			
	Growth Rate of Stocks		7.5		Payout Rate to Beneficiar		0			
	Beginning Year		2005		TWU fee 6.0% of income, 0.3% of principal					
	Income bene pays income fee				Principal fee paid by trust					

Year	Calendar Year	Beginning Value	Interest Income	Dividend Income	Gross Income	Tax owed on Dividends	Net Income After Trust Fee and Divd tax	Capital Gain Realized During Year	tal Gains Payable By Trust	Principal Mgmt Fee
0	2005	5,000,000	80,000	60,000	140,000	12,600	131,600	56,250	11,813	15,000
1	2006	5,198,188	83,171	62,378	145,549	13,099	124,216	58,480	12,281	15,595
2	2007	5,404,231	86,468	64,851	151,318	13,619	129,140	60,798	12,767	16,213
3	2008	5,618,441	89,895	67,421	157,316	14,158	134,259	63,207	13,274	16,855
4	2009	5,841,142	93,458	70,094	163,552	14,720	139,580	65,713	13,800	17,523
5	2010	6,072,670	97,163	72,872	170,035	15,303	145,113	68,318	14,347	18,218
6	2011	6,313,376	101,014	75,761	176,775	15,910	150,865	71,025	14,915	18,940
7	2012	6,563,622	105,018	78,763	183,781	16,540	156,845	73,841	15,507	19,691
8	2013	6,823,788	109,181	81,885	191,066	17,196	163,062	76,768	16,121	20,471
9	2014	7,094,265	113,508	85,131	198,639	17,878	169,525	79,810	16,760	21,283
10	2015	7,375,464	118,007	88,506	206,513	18,586	176,245	82,974	17,425	22,126
15	2020	8,957,752	143,324	107,493	250,817	22,574	214,055	100,775	21,163	26,873
20	2025	10,879,495	174,072	130,554	304,626	27,416	259,977	122,394	25,703	32,638
25	2030	13,213,516	211,416	158,562	369,978	33,298	315,751	148,652	31,217	39,641
30	2035	16,048,265	256,772	192,579	449,351	40,442	383,491	180,543	37,914	48,145
35	2040	19,491,164	311,859	233,894	545,753	49,118	465,762	219,276	46,048	58,473
40	2045	23,672,681	378,763	284,072	662,835	59,655	565,684	266,318	55,927	71,018
	Cumulative						11,834,918			

CLIENT	Smith Family Trust	
Beginning Value	$5,000,000	% Allocation - Stocks	80	Taxes are paid by beneficiaries out of gross
Yield on Stocks	2.00	% Allocation - Bonds	20	Year end value is reduced by management fee.
Yield on Bonds	4.00			Bond income is tax free
		Cap. Gains Tax rate	21	Management fee in illustration is 0.7%
Growth Rate of Stocks	6.00	Turnover Rate, Stocks	25	
Beginning Year	2005	Payout Rt to Beneficiary	3.50	

Year	Calendar Year	Beginning Value	Cash Payout to Beneficiaries	Interest Income	Dividend Income	Gross Income	Capital Gain Realized During Year	Capital Gain Tax	Tax on Dividends	Total Tax Paid By Beneficiary	Total Mgmt Fee	Net Cash to Beneficiary After Taxes
0	2005	5,000,000	175,000	40,000	80,000	120,000	60,000	12,600	16,800	29,400	35,000	145,600
1	2006	5,150,000	180,250	41,200	82,400	123,600	60,900	12,789	17,304	30,093	36,050	150,157
2	2007	5,304,500	185,658	42,436	84,872	127,308	61,092	12,829	17,823	30,652	37,132	155,005
3	2008	5,463,635	191,227	43,709	87,418	131,127	61,284	12,870	18,358	31,228	38,245	160,000
4	2009	5,627,544	196,964	45,020	90,041	135,061	61,477	12,910	18,909	31,819	39,393	165,145
5	2010	5,796,370	202,873	46,371	92,742	139,113	61,671	12,951	19,476	32,427	40,575	170,446
6	2011	5,970,261	208,959	47,762	95,524	143,286	61,865	12,992	20,060	33,052	41,792	175,907
7	2012	6,149,369	215,228	49,195	98,390	147,585	62,060	13,033	20,662	33,695	43,046	181,533
8	2013	6,333,850	221,685	50,671	101,342	152,012	62,256	13,074	21,282	34,355	44,337	187,329
9	2014	6,523,866	228,335	52,191	104,382	156,573	62,452	13,115	21,920	35,035	45,667	193,300
10	2015	6,719,582	235,185	53,757	107,513	161,270	62,648	13,156	22,578	35,734	47,037	199,451
15	2020	7,789,837	272,644	62,319	124,637	186,956	63,641	13,365	26,174	39,539	54,529	233,106
20	2025	9,030,556	316,069	72,244	144,489	216,733	64,650	13,577	30,343	43,919	63,214	272,150
25	2030	10,468,890	366,411	83,751	167,502	251,253	65,675	13,792	35,175	48,967	73,282	317,444
30	2035	12,136,312	424,771	97,090	194,181	291,271	66,716	14,010	40,778	54,788	84,954	369,983
35	2040	14,069,312	492,426	112,554	225,109	337,663	67,773	14,232	47,273	61,505	98,485	430,921
40	2045	16,310,189	570,857	130,482	260,963	391,445	68,847	14,458	54,802	69,260	114,171	501,596
	Cumulative		13,766,077									11,887,660

CLIENT	Smith Family Trust	
Beginning Value	$5,000,000	
Yield on Stocks	2.00	
Yield on Bonds	4.00	
Growth Rate of Stocks	7.50	
Beginning Year	2005	
% Allocation - Stocks	80	Taxes are paid by beneficiaries out of gross
% Allocation - Bonds	20	Year end value is reduced by management fee.
		Bond income is tax free
Cap. Gains Tax rate	21	Management fee in illustration is 0.7%
Turnover Rate, Stocks	25	
Payout Rt to Beneficiary	3.50	

Year	Calendar Year	Beginning Value	Cash Payout to Beneficiaries	Interest Income	Dividend Income	Gross Income	Capital Gain Realized During Year	Capital Gain Tax	Tax on Dividends	Total Tax Paid By Beneficiary	Total Mgmt Fee	Net Cash to Beneficiary After Taxes
0	2005	5,000,000	175,000	40,000	80,000	120,000	75,000	15,750	16,800	32,550	35,000	142,450
1	2006	5,210,000	182,350	41,680	83,360	125,040	76,406	16,045	17,506	33,551	36,470	148,799
2	2007	5,428,820	190,009	43,431	86,861	130,292	76,707	16,108	18,241	34,349	38,002	155,659
3	2008	5,656,830	197,989	45,255	90,509	135,764	77,009	16,172	19,007	35,179	39,598	162,810
4	2009	5,894,417	206,305	47,155	94,311	141,466	77,312	16,236	19,805	36,041	41,261	170,264
5	2010	6,141,983	214,969	49,136	98,272	147,408	77,617	16,300	20,637	36,937	42,994	178,033
6	2011	6,399,946	223,998	51,200	102,399	153,599	77,922	16,364	21,504	37,868	44,800	186,131
7	2012	6,668,744	233,406	53,350	106,700	160,050	78,229	16,428	22,407	38,835	46,681	194,571
8	2013	6,948,831	243,209	55,591	111,181	166,772	78,537	16,493	23,348	39,841	48,642	203,368
9	2014	7,240,682	253,424	57,925	115,851	173,776	78,846	16,558	24,329	40,886	50,685	212,537
10	2015	7,544,791	264,068	60,358	120,717	181,075	79,157	16,623	25,350	41,973	52,814	222,094
15	2020	9,267,995	324,380	74,144	148,288	222,432	80,728	16,953	31,140	48,093	64,876	276,287
20	2025	11,384,773	398,467	91,078	182,156	273,235	82,330	17,289	38,253	55,542	79,693	342,925
25	2030	13,985,016	489,476	111,880	223,760	335,640	83,963	17,632	46,990	64,622	97,895	424,854
30	2035	17,179,146	601,270	137,433	274,866	412,300	85,629	17,982	57,722	75,704	120,254	525,566
35	2040	21,102,804	738,598	168,822	337,645	506,467	87,328	18,339	70,905	89,244	147,720	649,354
40	2045	25,922,612	907,291	207,381	414,762	622,143	89,061	18,703	87,100	105,803	181,458	801,489
	Cumulative		18,342,802									15,872,501

UNI-TRUST CONVERSION PROCEDURE UNDER KENTUCKY'S PRINCIPAL AND INCOME ACT

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I. Identifying the Candidates

A. Income Only Trusts – These are trusts which provide the Trustee with no discretion to distribute principal to the current beneficiary. If the Trustee has been investing in traditional securities, it is likely that the income yield generated by the trust has declined but the principal value of the trust is stagnant or has increased.

B. Blended Families – Not necessarily limited to blended families, this is the situation where the Trustee may have discretion to distribute principal but the remainder beneficiaries challenge every discretionary distribution because it may decrease their remainder share.

C. Tax Sensitive Beneficiaries – One of the reasons dividend yield declined in the past is that, prior to recent tax acts, dividends were taxed at a higher rate than capital gains. Interest income is still taxed at a higher rate than capital gains in most cases. The beneficiaries may have a desire to generate distributions but prefer to recognize those distributions as a capital gain rather than ordinary income.

D. Investment Mix Disagreement – This is the traditional conflict between current and remainder beneficiaries where the current beneficiaries wish to invest for current yield and remainder beneficiaries wish to invest for capital appreciation which, in an income only trust, decreases the current distributions.

E. Trusts Holding a Single Security – Occasionally, a trust will hold a large block of a single security which, due to basis issues or the direction of the Settlor, can't be sold. If the single security generates very little yield it may be possible to convert to a uni-trust to increase the yield to the beneficiary.

II. Make Sure None of the Statutory Prohibitions Apply (KRS 386.454(4) &(7)). A Trustee may not make an adjustment:

A. That diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the fiduciary did not have the power to make the adjustment;

   i.e. A QTIP Trust yielding 6% but desire to convert to a 4% uni-trust

B. That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

C. That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

   i.e. A currently existing uni-trust

D. From any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

   i.e. Charitable remainder trusts

E. If possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust or estate for income tax purposes, and the individual would not be treated as the owner if the fiduciary did not possess the power to make an adjustment;

F. If possessing or exercising the power to make an adjustment causes all or part of the trust or estate assets to be included for estate tax purposes in the estate of an individual who has the power to remove a fiduciary, appoint a fiduciary, or both, and the assets would not be included in the estate of the individual if the fiduciary did not possess the power to make an adjustment;

G. If the fiduciary is a beneficiary of the trust or estate (includes both income and remainder beneficiaries); or

H. If the fiduciary is not a beneficiary, but the adjustment would benefit the fiduciary directly or indirectly; except that any effect on the fiduciary's compensation shall not preclude an adjustment so long as the fiduciary's fees are reasonable and otherwise comply with the applicable law.

I. If it is clear from the terms of the trust that the terms are intended to deny the fiduciary the power of adjustment.

III. Laying the Groundwork

A. If any of the prohibitions above apply to some, but not all of the Co-Trustees, KRS 385.454(5) allows for the unaffected Co-Trustee to make the adjustment.

B. If the trust is not a Trust Under Will, it will be necessary to register the trust with the district Court.

1. If appointing a Co-Trustee to solve one of the above prohibitions it will likely be necessary to file an AOC Petition for Appointment, Certificate of Qualification and Fiduciary Bond

C. Gather consensus of beneficiaries (KRS 386.450(3))

1. Consent of current beneficiaries

2. Consent of remainder beneficiaries in the oldest class

a. If any remainder beneficiaries in the oldest class are minors, it will be necessary to appoint a Guardian Ad Litem

D. Arrive at a distribution method

1. Statute states that adjustment may not be less than three percent (3%) or more than five percent (5%)

2. Rolling Averages to smooth out any sharp market shifts are popular

IV. Contents of the Petition and Order

A. An Individual Trustee must elect to be governed by the Prudent Investor Rule (KRS 287.277)

B. Identify the trust language at issue

C. State that it is impossible for the Trustee to administer the trust impartially as required by KRS 386.452(2)

D. I always include a statement that either (i) none of the prohibitions of KRS 386.454(4) apply or that (ii) a prohibition would have applied but for the included solution

E. Waivers from the current and remainder beneficiaries will need to be attached and Judge may also require attendance at Motion. If GAL is appointed, report will need to be entered.

F. Draft the Order in a manner that can be easily interpreted and implemented by the Trustee.

G. The Order should also be as flexible as possible such as giving the Trustee the discretion to allocate principal to income annually without the necessity of further motions to the Court.

V. Follow Up Work

A. If the trust was not a Trust Under Will, a motion to release the registration of the trust should follow entry of the Order granting the adjustment.

B. Confirm that the Accountant and Trustee are all in agreement as to how the adjustment Order should be interpreted and the adjustment calculations conducted.

287.277 Standards for bank or trust company acting as fiduciary.

(1) Notwithstanding the provisions of any other law, a bank empowered to act as a fiduciary or trust company, when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property held in a fiduciary capacity, shall act as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the fiduciary account.

(2) The standard described in subsection (1) of this section requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the account portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the account.

(3) In making and implementing investment decisions, the bank or trust company has a duty to diversify the investments of the account unless, under the circumstances, it is prudent not to do so.

(4) In addition, the bank or trust company shall:

(a) Conform to fundamental fiduciary duties of loyalty and impartiality;

(b) Act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and

(c) Incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the account.

(5) The duties of the bank or trust company under this section are subject to the rule that in investing the funds of the account, the bank or trust company:

(a) Has a duty to the beneficiaries of the account to conform to any applicable statutory provisions governing investment by fiduciaries; and

(b) Has the power expressly or impliedly granted by the terms of the account or applicable instrument and has a duty to the beneficiaries of the account to conform to the terms of the account directing or restricting investments by the bank or trust company.

Effective: July 15, 1996

History: Created 1996 Ky. Acts ch. 338, sec. 6, effective July 15, 1996.

386.450 Definitions for Kentucky Principal and Income Act, KRS 386.450 to 386.504.

(1) "Accounting period" means a calendar year unless another twelve (12) month period is selected by a fiduciary. The term includes a portion of a calendar year or other twelve (12) month period that begins when an income interest begins or ends when an income interest ends;

(2) "Beneficiary" includes, in the case of a decedent's estate, an heir, legatee, and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary;

(3) "District Court approval" means the consent of:

  (a) All current beneficiaries;

  (b) All remainder beneficiaries in the oldest generation; and

  (c) The court;

(4) "Fiduciary" means a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, and public administrator;

(5) "Income" means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in Articles 4 and 5 of the Kentucky Principal and Income Act;

(6) "Income beneficiary" means a person to whom net income of a trust is or may be payable;

(7) "Income interest" means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion;

(8) "Mandatory income interest" means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute;

(9) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under KRS 386.450 to 386.504 to or from income during the period;

(10) "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates;

(11) "Remainder beneficiary" means a person entitled to receive principal when an income interest ends;

(12) "Terms of a trust" means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct; and

(13) "Trustee" includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.

Effective: January 1, 2005

History: Created 2004 Ky. Acts ch. 158, sec. 1, effective January 1, 2005.

386.452 Fiduciary duties.

(1) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of Articles 2 and 3 of the Kentucky Principal and Income Act, a fiduciary:

(a) Shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in KRS 386.450 to 386.504;

(b) May administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by KRS 386.450 to 386.504;

(c) Shall administer a trust or estate in accordance with KRS 386.450 to 386.504 if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(d) Shall add a receipt or charge a disbursement to principal to the extent that neither the terms of the trust nor KRS 386.450 to 386.504 provide a rule for allocating the receipt or disbursement to or between principal and income.

(2) In exercising the power to adjust under KRS 386.454(2) or (3) or a discretionary power of administration regarding a matter within the scope of KRS 386.450 to 386.504, whether granted by the terms of a trust, a will, or KRS 386.450 to 386.504, a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest a contrary intention. Except as provided in this subsection, determination in accordance with KRS 386.450 to 386.504 shall be presumed to be fair and reasonable to all of the beneficiaries.

Effective: January 1, 2005

History: Created 2004 Ky. Acts ch. 158, sec. 2, effective January 1, 2005.

386.454 Trustee's power to adjust -- Personal representative's power to adjust -- Circumstances prohibiting adjustment.

(1) Notwithstanding any provision of Kentucky law to the contrary, the trustee of a trust to which by law KRS 287.277 does not apply may elect to have such provisions apply to the administration of the trust with approval of the District Court.

(2) A trustee may adjust between principal and income to the extent the trustee considers necessary if KRS 287.277 applies by law or by election made and approved under subsection (1) of this section, the terms of the trust describe the amount that may or shall be distributed to a beneficiary by referring to the trust's income, the trustee determines, after applying the rules in KRS 386.452(1), that the trustee is unable to comply with KRS 386.452(2) and the adjustment, including an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually, is approved by the District Court.

(3) A personal representative may adjust between principal and income in the same manner as a trustee if KRS 287.277 applies to the personal representative by law or if the personal representative elects to have KRS 287.277 apply to the administration of the estate, upon approval of the District Court, which approval may be an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually, and:

   (a) The amount distributable to a beneficiary of the estate is determined by reference to the income of the estate; and

   (b) The personal representative determines, and after applying the rules of KRS 386.452(1), that the personal representative is unable to comply with KRS 386.452(2).

(4) A fiduciary shall not make an adjustment:

   (a) That diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the fiduciary did not have the power to make the adjustment;

   (b) That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

   (c) That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

   (d) From any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

   (e) If possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust or estate for income tax purposes, and the individual would not be treated as the owner if the fiduciary did not possess the power to make an adjustment;

   (f) If possessing or exercising the power to make an adjustment causes all or part of the trust or estate assets to be included for estate tax purposes in the estate of an individual who has the power to remove a fiduciary, appoint a fiduciary, or both, and the assets would not be included in the estate of the individual if the fiduciary did not possess the power to make an adjustment;

(g) If the fiduciary is a beneficiary of the trust or estate; or

(h) If the fiduciary is not a beneficiary, but the adjustment would benefit the fiduciary directly or indirectly; except that any effect on the fiduciary's compensation shall not preclude an adjustment so long as the fiduciary's fees are reasonable and otherwise comply with the applicable law.

(5) If paragraph (e), (f), (g), or (h) of subsection (4) of this section applies to a fiduciary and there is more than one (1) fiduciary, a cofiduciary to whom the provision shall not apply may make the adjustment unless the exercise of the power by the remaining fiduciary or fiduciaries is not permitted by the terms of the trust.

(6) A fiduciary may release the entire power conferred by subsection (2) or (3) of this section or may release only the power to adjust from income to principal or the power to adjust from principal to income if the fiduciary is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (a) to (f) of subsection (4) of this section or paragraph (h) of subsection (4) of this section, or if the fiduciary determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (4) of this section. The release may be permanent or for a specified period, including a period measured by the life of an individual. Such release shall require approval of the District Court. Further, with approval of the District Court, a fiduciary may divide a trust into one (1) or more fractional shares if the division does not change the beneficial interests.

(7) Terms of a trust or will that limit the power of a fiduciary to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust or will that the terms are intended to deny the fiduciary the power of adjustment conferred by subsection (2) or (3) of this section.

Effective: January 1, 2005

History: Created 2004 Ky. Acts ch. 158, sec. 3, effective January 1, 2005.

Legislative Research Commission Note (1/1/2005). In 2004 Ky. Acts ch. 158, sec. 3, subsec. (2), a reference is made to "subsection (1) of this Act." Because it is clear from the subject matter of ch. 158, sec. 3, subsec. (1), that the reference was intended to be to "subsection (1) of this section" instead, this manifest clerical or typographical error has been corrected during codification by the Reviser of Statutes under KRS 7.136(1).

REPRESENTING ATTORNEYS IN-FACT, GUARDIANS, CONSERVATORS AND OTHER FIDUCIARIES:

Liability Issues For Estate Planners

Matthew W. Breetz
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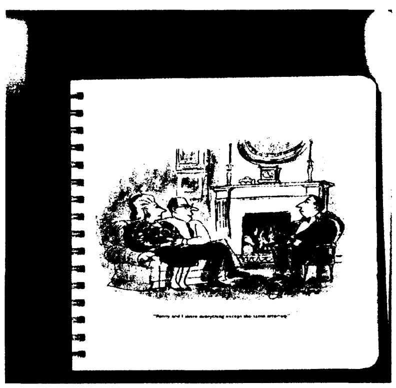
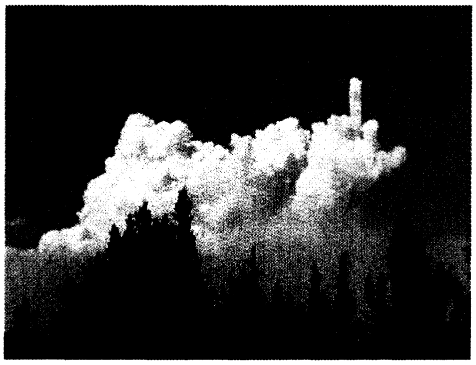
SECTION D

REPRESENTING ATTORNEYS IN-FACT, GUARDIANS, CONSERVATORS AND OTHER FIDUCIARIES

Matthew W. Breetz
Stites & Harbison, PLLC
July 21, 2005
32nd Annual Midwest/Midsouth Estate Planning Institute

LIABILITY ISSUES FOR ESTATE PLANNERS





Recent Trends In Legal Malpractice Cases

- In 1985, 6.97 % of all legal malpractice claims were found in the area of estate, trust and probate.
- In 1995, the percentage rose to 7.59%.
- Given changes in privity, fiduciary duty, conflicts of interest, statute of limitations, the percentage will likely rise in 2005.

- 50% of all claims can be attributed to five types of alleged errors:
  - Failure to know or properly apply the law;
  - Planning or procedural errors;
  - Inadequate discovery or investigation;
  - Failure to obtain client consent; and,
  - Procrastination in Performance

Helpful Hints

- "Heirs always sue."
- "Clients sue too because they expect work that the attorney has not agreed to do."
- "Always, always, always write very specific retainer letters outlining EXACTLY the services the attorney will perform, listing each client, and listing non-clients who would typically be beneficiaries."
- "Beware of conflicts, or relationships that can be perceived as conflicts later on."
- "Don't undo for one family member what you've done for another."
- "Document your file."
- "Explain alternatives to common problems, and discuss the risks associated with the problems and the possible solutions. Document those discussions."

PRIVITY? WHAT'S THAT?

- The Strict Privity Rule: Only the testator or the testator's estate may sue for malpractice.
- The Third Pary Beneficiary Rule: Third party beneficiaries to a will or an estate plan may sue the attorney for malpractice. Some states require the person to simply be named in the estate planning documents, while others require the beneficiary to prove that the purpose of the estate plan was to benefit him.
- Hybrid Approach: Some states balance various factors, including the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to the plaintiff, the degree of certainty that the plaintiff suffered the injury, the closeness of connection between the defendant's conduct and the injury, and public policy considerations.

O'Bryan v Cave

- In July of 1997, Mr. and Mrs. Cave met with O'Bryan to discuss estate plan.
- O'Bryan talked about the right of Mrs. Cave to renounce against Mr. Cave's ultimate estate plan.
- O'Bryan discussed a joint tenacy with right of survivorship to their home, and told Mr. Cave the property would go to his wife upon his death without probate.
- In August of 1997, Mr. Cave returned
  - deeded home to wife, joint tenancy with right of survivorship
  - willed the residue to his sisters and nephews.

In 1999, Mr. Cave died. O'Bryan, who never advised Mrs. Cave of her renunciation rights and did not represent her, prepared a renunciation of the will.

Mr. Cave's nephew sued, claiming O'Bryan failed to advise his uncle of his right to renounce and the effect of the deed, and he was deprived of his inheritance

- O'Bryan moved for summary judgment before the trial court, arguing there was no evidence of a failure on his part to advise Mr. Cave of his wife's renunciation rights and there was no expert testimony that he violated the standard of care.
- The plaintiff found an expert witness, and also argued that *res ipsa loquitur* applied because O'Bryan wrote a will that did not work as Mr. Cave intended.
- The trial court granted summary judgment. While the plaintiff found an expert witness, the court found that no evidence existed to refute O'Bryan's testimony that he told Mr. Cave about his wife's renunciation rights.
- The trial court also found that the plaintiff had no standing since O'Bryan never represented him.
- The Court of Appeals, in an April 2004 Opinion to be published, reversed and remanded.
- On standing, the court concluded "an attorney owes a duty of care to the direct, intended, and specifically identifiable beneficiaries of the estate planning client, notwithstanding a lack of privity." The court did not address whether persons not named in estate planning documents could sue.
- On the other issue, since the plaintiff identified an expert who would opine that O'Bryan violated the standard of care, and since the only evidence in the record was O'Bryan's, and it was "self-serving", and since the plaintiff "was never given the opportunity to depose" Mrs. Cave, issues of material fact existed.

- On April 13, 2005 the Supreme Court granted discretionary review.
- O'Bryan argues a number of points to the Supreme Court.
- Mr. Cave's nephew has not filed his brief.

Limits to the Expansion of Standing Are Developing, In All Places, In California

- Moore v Anderson, Zeigler, Disharoon, Gallagher & Gray, 109 Cal.App.4th 1287 (Ca.Ct.App. 2003) – an attorney preparing a will for a testator owes no duty to the beneficiaries of the new will, or previous wills, to ascertain and document the client's testamentary capacity.
- Boranian v Clark, 20 Cal.Rptr. 405 (Ca.Ct. App. 2004) – a lawyer's primary duty is owed to his client, and when there is a question about whether a third-party beneficiary was the intended beneficiary, and the beneficiary claims the lawyer failed to adequately ascertain the testator's intent or capacity, the lawyer will not be held accountable to the beneficiary.
- Featherson v Farwell, 20 Cal.Rptr. 412 (Ca.Ct.Ap. 2004) – where there are questions about the client's intent to favor one adult child over another, the lawyer will not be held accountable to either child.

Don't Forget The Attorney/Client Privilege

- In Gould, Larson, Bennet, Wells and McDonnell v. Panico, 869 A.2d 653 (Conn.Sup.Ct. 2005), the court held that an attorney who met with her client and discussed the client's estate plans, but did not prepare a will for the client, could not be compelled to disclose the confidential communications between them in a will contest action.
- "The importance of a testator's ability to discuss his testamentary intentions candidly and the concomitant professional advice needed from an attorney in regard to drafting the will to effectuate those intentions is paramount." Id. at 657.
- Distinguished between situations when an attorney who prepares a will can be required to disclose all she knows about the testator's state of mind.

Conflicts of Interest

- Married couples
- Second marriages
- Substantial assets
- Desire to leave to persons other than spouse

- ABA Formal Opinion 05-434
  - There ordinarily is no conflict of interest when a lawyer is engaged by a testator to disinherit a beneficiary whom the lawyer represents on unrelated matters, unless doing so would violate a legal obligation of the testator to the beneficiary or unless there is a significant risk that the lawyer's representation of the testator will be materially limited by the lawyer's responsibilities to the beneficiary.

Fiduciary Duty Cases

- Nesvig v Nesvig, 676 N.W.2d 73 (N.D.Sup.Ct. 2004) – an attorney who undertakes to manage or invest a client's money assumes broader responsibilities than merely establishing an agreement with the client and acting in good faith regarding return of the money. When a client entrusts the net proceeds of his recovery to his attorney to properly invest, safeguard and manage, the attorney has a fiduciary duty to properly advise his client above and beyond the requirements of the rules of professional conduct.

- Reynolds v Schrock, 107 P.3d 52 (Or.Ct.App. 2005) – an attorney who drafts an agreement between a client and a third party, knowing that the client and third party are in a fiduciary relationship, might draft an agreement imposing duties on the client falling short of what one fiduciary owes another. In that situation, if the attorney knows the fiduciary relationship imposes a higher standard of conduct than the agreement, then the attorney who advises the client that he may do an act that the contract permits but the that is incompatible with the fiduciary relationship may be liable for the breach of the fiduciary duty.

- Traub v Washington, 591 S.E.2d 382 (Ga.Ct.App. 2003)

The Baker Botts Case

- Kathleen and Floyd Cailloux – married 55 years
- They had two children, Kenneth Cailloux and Paula Heilman, and one grandchild, Stephen.
- Baker Botts – law large firm
- Neil Griffin – majority owner to the First National Bank of Kerrville, now Wells Fargo
- William Goertz – an officer at Wells Fargo
- Stacy Eastland – a Baker Botts lawyer
- Stephen Dyer – a Baker Botts lawyer

SELECTED WAIVER AND ELECTION PITFALLS WHICH COMMONLY ARISE IN PROBATE

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SECTION E

SELECTED WAIVER AND ELECTION PITFALLS WHICH COMMONLY ARISE IN PROBATE

SELECTED WAIVER AND ELECTION PITFALLS WHICH COMMONLY ARISE IN PROBATE

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Decision making is a constant process in probate. In making these decisions, the attorney is constantly seeking to avoid pitfalls. This paper addresses selected common pitfalls which arise from waiver and elections in probate.

I. THE INITIAL PITFALL: WHO IS YOUR CLIENT?

The probate bar is indebted to the Kentucky Bar Association for Ethics Opinion E-401, which is appended to this paper as Exhibit B. Released in 1997, E-401 stands for the proposition that the individual, who is the personal representative, is the client of the attorney. While E-401 is a rather lengthy opinion, the general rule is that the attorney represents the individual who is the personal representative. The attorney does not represent "the estate" or "the trust" or "the beneficiaries."

This assumes, however, that the attorney avoids the initial pitfall. The attorney who elects to advise the family that he or she represents "the estate" or someone other than the personal representative mounts the horns of a dilemma.

II. ELECTING WHO WILL PROVE THE WILL.

A Kentucky statute provides that any taker under a Will, and his or her spouse, will lose the bequest, if he or she proves the Will and "the will cannot otherwise be proved", subject to a potential savings clause:

> Unless such witness would be entitled to a share of the estate of the testator if the will were not established, in which case he shall receive so much of his share as does not exceed the value of that devised or bequeathed. KRS 394.210; <u>Floore v. Green</u>, 83 S.W. 133 (Ky. 1904).

III. WAIVER OF RIGHT TO SERVE AS PERSONAL REPRESENTATIVE.

For a variety of reasons, your client may decide not to serve as personal representative, in spite of being named in a valid Will. One obvious fact pattern calling for waiver of the right to serve as personal representative is where the nominee intends to file a Will contest proceeding. One who undertakes to qualify as personal representative of an estate makes an irrevocable election to abide by the Last Will and Testament, when he or she "has knowledge of all the facts at the time." It also appears that this election may not be cured by a subsequent resignation by the personal representative. Frank's Adm'r v. Bates, 97 S.W.2d 549 (Ky. App. 1936).

IV. THE ELECTION TO TAKE AGAINST THE WILL.

When a husband or wife dies testate, the surviving spouse may, though under full age, release what is given unto him or her by the Will, if any, and receive his or her share under KRS 392.020 as if no Will had been made. In such case, however, the share in any real estate which the surviving spouse takes shall be only one-third (1/3) of such real estate.

Such renunciation shall be made within six months after probate and acknowledged before and left for record with the county clerk or his authorized deputy in the country where probate was made, or acknowledged before a subscribing witness and proved before and left with the county clerk or his authorized deputy. KRS 392.080. If within those six months an action contesting the Will is brought, the surviving spouse need not make such relinquishment until within six months succeeding the time when the action is disposed of. KRS 392.080(1). However, the period for renunciation may be extended not exceeding six additional months by order entered by the district court upon application of the surviving spouse for such extension within six months after the date of probate. KRS 392.080.

Renunciation of the Will necessarily disrupts the scheme of the deceased as to the distribution of his or her estate. Aspects of the effect are treated in the U.K. CLE publication *Kentucky Estate Administration, Third Edition* (2000) at Sections 1.23; 1.24 and 8.14.

Of particular interest, where the decedent had established a Revocable Trust, is whether the spouse who would benefit from the provisions of the Revocable Trust is required to renounce those benefits to be received from that Trust, if the spouse is renouncing the Will. This curious circumstance has also not been addressed by the Kentucky General Assembly, although "corrective legislation" has been lifted up. At first blush, it might appear that the surviving spouse, who renounces a Will under KRS Chapter 392, is apparently not adversely impacted upon receiving the benefits of the Revocable Trust created by the deceased spouse during his or her lifetime, unless there is contrary language in the trust document. Harper v. Commissioner, 93 T.C. No. 32 (1989). See Carnahan v. Stallman, 29 Ohio App.3rd 293, 504 N.E.2d 1218 (1986).

Massachusetts was one of the first states to consider whether a surviving spouse, who is not mentioned in a Revocable Trust, may reach its assets if it was funded during the marriage. The Massachusetts rule for many decades was that the surviving spouse could not reach the assets in the Revocable Trust, upon renouncing the Will. As subsequent states addressed the issue, the consensus was to adopt "the Massachusetts rule." However, in the leading case of Sullivan v. Burkin, 390 Mass. 864, 460 N.E.2d 572 (1984), the highest appellate court of Massachusetts abolished "the Massachusetts rule" and allowed surviving spouses to receive revocable trust assets "as to any inter vivos trust created or amended after the date of this Opinion."

V. WAIVER OF RIGHT TO ELECT AGAINST WILL.

Apparently, the most common way to fail to elect against the Will is to fail to follow the statutory procedure. The execution of a renunciation instrument, the filing of the instrument with the district court and even the service of the instrument upon the personal representative are not adequate to renounce the Will. The correct procedure involves the county clerk, and strict compliance may be required.

VI. WAIVER BY ACCEPTANCE OF BENEFITS UNDER THE WILL.

It is clearly established that where the surviving spouse accepts the provisions for her in her husband's Will, she cannot thereafter claim a right to share in undevised property. Rhodus v. Proctor, 433 S.W.2d 625 (Ky. 1968).

Thus, the execution of a receipt for the personal property bequeathed to the surviving spouse may be adequate to waive the right of the surviving spouse to renounce the Will. Sanders v. Pierce, 979 S.W.2d 457 (Ky.App. 1998).

It has also been held that if the widow fails to renounce the Will of her husband, then she must take the estate given her by the Will subject to all claims against it and she must comply with a direct request or direction attached to the devise. Huhlien v. Huhlien, 8 S.W. 260 (Ky. 1888).

VII. WITHDRAWAL OF RENUNCIATION.

An accomplished renunciation under this section is not revocable at the pleasure of the widow. But recall of the election may be granted under the equitable powers of the court. Craven v. Craven, 181 Ky. 428, 205 S.W. 406 (1918).

VIII. WAIVER OF RIGHT TO ELECT AGAINST WILL BY WRITTEN AGREEMENT.

It is clear that persons about to wed can waive the right to elect against the Will by the execution of a prenuptial agreement. In a Will contract case, however, it was held that the Will contract did not bar renunciation of the Will, where no such provision was included within the contract. Bauer v. Piercy, 912 S.W.2d 457 (Ky.App. 1995).

At the UK/CLE 2004 Annual Estate Planning Institute, a panel discussed the issue of separate counsel for a couple about to wed regarding prenuptial agreements. A question was also raised regarding whether the spouses should have separate counsel for such a waiver relating to a post-nuptial agreement. Years ago, the writer requested the Kentucky Bar Association to render a formal opinion, including whether one attorney could represent both parties to a prenuptial agreement. The Opinion is appended to this paper. KBA Ethics Opinion E-290 (Exhibit C) concluded that it is usually not proper for the attorney representing one spouse in a prenuptial agreement negotiation to "answer questions" of the other spouse. The Opinion notes, in part:

> Assuming that the agreement contemplated by the parties does not offend public policy, joint representation may threaten the exercise of counsel's independent professional judgment if one or the other of the parties is unwilling to be completely forthcoming . . . .
>
> . . . If counsel is possessed of confidences or secrets of a party that the other needs to know and that party is not willing to disclose such information, it is obvious that counsel would, at the very least, violate DR 5-150 by purporting to represent both.

IX. WAIVER OF CLAIMS.

Kentucky's claims statutes were taken in great measure from parallel provisions of the Uniform Probate Act. Generally all claims against a decedent's estate, which rose before the death of the decedent, are barred, if not barred earlier by other statute of limitations, against the estate, the personal representative and heirs and devisees of the decedent unless presented within six months after the appointment of the personal representative. If no personal representative has been appointed, they are barred if no claim has been filed within two years of the decedent's death.

This section does not impact any proceeding to enforce a mortgage, pledge, lien or other security interest securing an obligation of the decedent or upon property of the estate. The section also does not affect the limits of the insurance protection only in any proceeding to establish the liability of the decedent or the personal representative for which he is protected by liability insurance.

Also excluded are claims of the United States, the state of Kentucky and any subdivision thereof.

Kentucky practitioners have generally relied upon this self-effectuating statute of limitations for claims against personal representatives. However, the Tulsa Collections decision by the United States Supreme Court in 1987[1] raised

[1] Tulsa Professional Collection Services v. Pope, 485 US 478 (1987).

questions regarding the enforceability of self-executing statutes of limitation. There is an excellent treatment of this topical by James E. Hargrove, Esq. and Walter R. Morris, Jr., Esq. in the Chapter entitled, Claims Against the Estate in *Kentucky Estate Administration, Third Edition*, published by UK/CLE.

X. WAIVER OF DEFENSES TO CLAIMS FILED AGAINST AN ESTATE.

Prior to the amendment to the claims statute to somewhat conform with the Uniform Probate Code, which amendment was effective July 15, 1988, a personal representative had no time limitation to respond to a claim against the estate beyond the normal course of the administration of the estate. KRS 396.055 now requires analysis and action by the personal representative.

> Failure of the personal representative to mail notice to a claimant of action on his claim for sixty (60) days after the time for original presentation of the claim has expired has the effect of a notice of allowance, except that upon petition of the personal representative and upon notice to the claimant, the court at any time before payment of such claim may for cause shown permit the personal representative to disallow such a claim. From KRS 396.055(1).

This statute was construed by the Court of Appeals in Kentucky in Patterson v. Estate of Boone, 150 S.W.3d 58 (Ky. App. 2003), where the Court of Appeals of Kentucky stated:

> Our legislature, in contrast, has specifically placed a limitation on the discretion of a personal representative to disallow a claim previously allowed by reason of inaction. We agree with the estate that the only time-limitation on the discretion to disallow the claim is that it must be done before payment. However, the legislature later provided that when the claim has been allowed by the personal representative's inaction, in order to later disallow the claim the representative is required to petition the court and to "show cause." Obviously, the legislature rejected the absolute right to disallow a claim previously allowed by the representative's inaction.
>
> The term "cause" is not defined in KRS 396.055. Nor does the statute explicitly state whether the showing of cause relates to the reason that the representative did not act on the claim before the expiration of sixty days, or to the merits of the claim itself. We find that when read in the context of the entire statute, the "cause" referred to in KRS 396.055(1) refers to a reasonable cause for not responding to the claim within the sixty-day period and not to the merits of the claim.

Although in Patterson, the district court conducted a hearing and refused to allow the personal representative to disallow the claim, on appeal the circuit court reversed. The Court of Appeals of Kentucky allowed the personal representative to disallow the claim. The Court of Appeals ruled that the personal representative, at the contested hearing, had overcome the presumption of allowance because of a need to accumulate a number of documents to make an informed decision about the claim.

In the recent decision of DeMoisey v. River Downs Investment Company, 159 S.W.3d 820 (Ky.App. 2005), the Court of Appeals of Kentucky held that the executor's failure to disallow a claim within the time limit prescribed by the statute converted a void debt into one required to be paid.

XI. WAIVER OF CLAIMS ASSERTED BY OR AGAINST DECEDENT.

As held in Snyder v. Snyder, 769 S.W.2d 70 (Ky.App. 1989):

> A personal representative does not automatically succeed to his decedent's rights and status as a litigant and thus is not a party to any suit against the decedent unless the action is revived. Daniel v. Fourth and Market, Inc., 445 S.W.2d 699 (Ky. 1968).
>
> CR 25.01(1) provides that if the proper substitution of parties is not made "within the period allowed by law . . . the action may be dismissed as to the deceased party." This rule does not arrogate to the courts a discretionary authority but allows for instances in which the right to have the action dismissed has been lost as by waiver, estoppel or consent.

KRS 395.278 permits reviver of an action in the name of the personal representative. In Snyder, this was held to be a statute of limitations and a mandatory time limit.

> "Thus, an action which is not revived within the one-year statutory period of this provision must be dismissed." Snyder, page 72.

XII. WAIVER BY ELECTION AGAINST COMPETING GRANTS.

The surviving spouse may be placed in a difficult position of electing to either accept the benefits under the Will or the benefit of being a joint tenant under one or more deeds. A surviving spouse who is also a surviving joint tenant has been held to be put to an election by a Will which purports to devise to the surviving spouse a life estate in the joint tenancy property, with the remainder being given to others. In such case, the surviving spouse must elect between keeping her own property and renouncing the gift under the Will on the one hand, or taking the gift under the Will and surrendering the joint tenancy interest. Kentucky Trust Company v. Kessel, 464 S.W.2d 275 (Ky. 1971) (Exhibit D); 5 Page on Wills §

47.13, at 618-619 (3rd rev.ed. 1962).

The 1980 Kentucky General Assembly apparently sought to abolish the doctrine of testamentary election by KRS 381.050(2):

> Where a conveyance or devise expressly creates a mutual right to the entirety by survivorship in real estate between a husband and wife, no provision of the Will of the husband or wife shall be construed to defeat such right to the entirety by survivorship of the surviving spouse.

The doctrine may still survive, however, since the waiver is created by the election, not by a "provision of the Will" of the deceased.

The doctrine of testamentary election is not limited to this fact pattern.

XIII. WAIVER BY FAILURE TO PROPERLY BIFURCATE A DIVORCE.

The death of a person still involved in a dissolution proceeding raises the question whether a bifurcated decree was properly drafted.

Kentucky law permits dissolution of marriage by an interlocutory decree, commonly known as "bifurcation" of the divorce proceedings under the authority of Putnam v. Fanning, 495 S.W.2d 175 (Ky. 1973). However, as noted in that decision, a bifurcated decree of dissolution of the marriage can have very little practical significance unless and until it is made final under Kentucky Civil Rule of Procedure 54.02. This rule requires that a judgment recite a determination that (a) there is no just reason for delay, and (b) that the order is final, where more than one claim for relief is presented. The potential horrendous results without such finality language can be seen in other jurisdictions in Cook v. Lobianco, 8 Ark.App. 60, 648 S.W.2d 808 (1983); and Pittman v. Pittman, 375 So.2d 415 (Miss. 1979).

XIV. WAIVER OF COMMUNITY PROPERTY RIGHTS.

Community property, which has been acquired in a community property state, does not lose its community property status by the owner moving to a common law state. To address these issues, Kentucky has enacted the Uniform Disposition of Community Property Rights at Death Act, found at KRS 391.210-.260. The Act applies to that portion of property traceable to a community source. A statutory presumption is created that all property acquired in a community property jurisdiction is community property. A rebuttable presumption is created that property taken in a form which creates rights of survivorship is not subject to the Act. KRS 391.215(2). Under KRS 391.220:

> Upon death of a married person, one-half of the [community]

> property . . . is the property of the surviving spouse and is not subject to testamentary disposition by the decedent or distribution under the laws of succession of this Commonwealth. One-half (1/2) of that property is the property of the decedent and is subject to testamentary disposition or distribution under the laws of succession of this Commonwealth. With respect to [community] property . . . the one-half (1/2) of the property which is the property of decedent is not subject to the surviving spouse's right to elect against the will.

Limited protection is given by the statute to the personal representative:

> . . . Neither the personal representative nor the court in which the decedent's estate is being administered has a duty to discover or attempt to discover whether property held by the decedent is [community] property . . . unless a written demand is made by the surviving spouse or the spouse's successor in interest. From KRS 391.225.

The Act also protects purchasers for value and lendors. KRS 391.235.

XV. WAIVER BY INTESTACY.

Can a parent favor one child over another child by giving the preferred child a parcel of real estate during the lifetime of the parent? The answer is "Qualified Yes." One should be assured that this parent has a valid Will in place and understand the severe consequences under present Kentucky statutes if the parent dies without a Will.

This serious problem can best be illustrated by the case of Frank (Exhibit E), who owned a farm of 110 acres. Frank had two children by his first marriage and three by his second marriage. Frank's second wife died when he was 63 years old. Six years later, he went to see his attorney. He had received considerable attention from the three children of his second marriage, and less attention by the two children of his first marriage. He asked his lawyer to draw a deed for "love and affection" to the three children by his second wife for 50 acres of the 110 acres. This was done. The record does not reflect whether the attorney suggested that Frank needed a Will, as well.

The next year, Frank died intestate. One of the children of his second marriage, Roy, was appointed administrator of the estate. Roy reduced the personal property to cash, paid the indebtedness of the estate and made distribution of the balance of the money among the five children of his father.

The two children by Frank's first marriage filed suit. They claimed that the conveyance of 50 acres to the three children of the second marriage was an "advancement" under KRS 391.140.

The three children of the second marriage countered that Frank and his lawyer had considered this possibility. The deed signed by Frank expressly provided, in part:

> It is expressly understood and agreed by the parties hereto that the conveyance of this land to the second parties by the first party is not in the nature of an advancement from the first party to the second parties, but is an absolute gift to them.

Relying upon the express language of KRS 391.140, the former Court of Appeals of Kentucky held that the conveyance of the 50 acres must be treated as an advancement if the consideration was "love and affection":

> The intention of the grantor in such cases, or the donor, does not govern. As has been held by this court, the purpose of the statute is to effect equality in distribution. If a parent gives a child, or certain of his children, a part only of his estate, and dies intestate as to the remainder, the law will take hold of the undisposed part and apply a sufficient amount of it to equalize the others with the favored ones, or to equalize them as far as may be done with the undisposed part of the estate.
>
> [Ecton v. Flynn, 229 Ky. 476, 17 S.W.2d 407, 410 (1929).]

It is too bad Frank did not have a Will, because this rule only arises in cases of intestacy.

Professor Carolyn Bratt of the University of Kentucky College of Law has criticized this rule. Kentucky apparently holds the distinction of being a minority of the only jurisdiction in the United States with this rule of law. Legislation seeking to change the ruling, however, has been rejected by the General Assembly of Kentucky.

No transaction between a husband and wife can be considered an advancement or be subject to the laws governing advancements. KRS 391.140(2); Talbott's Ex'r v. Goetz, 286 Ky. 504, 151 S.W.2d 369 (1941).

XVI. FRAUD ON THE DOWER.

Historically, Kentucky has not permitted a spouse to make a voluntary transfer of a significant portion of either his real or personal property with the intent to prevent his spouse from sharing in such property at his death. Martin v. Martin, 282 Ky. 411, 138 S.W.2d 509 (1940). If he does so, upon his death the spouse may assert her marital rights in such property in the hands of the donee.

Anderson v. Anderson, 583 S.W.2d 504 (Ky.App. 1979). Placing assets into joint bank accounts with others may constitute fraud on the dower. Harris v. Rock, 799 S.W.2d 10 (Ky. 1990). (Exhibit F)

The motive to defeat the statutory share of the spouse may be inferred from the circumstances of the case, and Kentucky courts have had little difficulty determining such intention where the gift is not reasonable in proportion to his estate. Benge v. Barnett, 309 Ky. 354, 217 S.W.2d 782 (1949). But a gift of $8,000 from an estate of $21,000 (38%) was held reasonable and not in fraud of the dower, when the gift was meant to provide for the children of the deceased husband. Goff v. Goff's Ex'rs, 175 Ky. 75, 193 S.W. 1009 (1917). A gift to siblings of as little as 45% of personalty may raise a presumption of fraud on the dower. Benge, *supra*.

XVII. WAIVER BY ADULTERY.

If either spouse voluntarily leaves the other and lives in adultery, the offending party forfeits by statute all right and interest in and to the property and estate of the other, unless they afterward become reconciled and live together as husband and wife. KRS 392.090(2); McQuinn v. McQuinn, 110 Ky. 321, 61 S.W. 358 (1901). The statute has been construed not to preclude recovery on a life insurance policy where the wife who was designated as beneficiary abandoned the husband and lived in adultery. Bradley v. Bradley's Adm'r, 178 Ky. 239, 198 S.W. 905 (1917). And the statute does not preclude allocation of employee benefits covered by ERISA. Moore v. Phillip Morris Companies, 8 F.3d 335 (6th Cir. 1993). The statute has also been construed as not precluding a wrongful death recovery by a spouse who deserted the deceased and lived in adultery. Napier's Adm'r v. Napier's Adm'r, 210 Ky. 163, 275 S.W. 379 (1925).

XVIII. ESTOPPEL BY ORIGINAL TITLE.

Where property is inherited by children and they decide to partition the real estate among themselves in division, the legal title to the partitioned real estate resides in the child ("child"), regardless of the provisions of the partition deed. It has been held that even where the partitioned deed adds the spouse of the child as a joint tenant with right of survivorship, such a provision is ineffective to change title from the child in fee simple to joint with right of survivorship with the child's spouse. Reynolds v. McGuire, 253 S.W.2d 386 (Ky. 1952).

XIX. MISCELLANEOUS.

There are so many waiver problems and election pitfalls in probate, it is impossible to cover them within one paper. Complete CLE presentations are made on many other elections and pitfalls, including, but not limited to:

1. DISCLAIMERS. These essential devices for current estate planning require

strict compliance with many requirements, including filing. Generally, a disclaimer which is given in exchange for a quid pro quo, for example, is invalid. Acceptance of the property interest is also a waiver of the right to disclaim. KRS 394.640.

2. QTIP ELECTIONS. A recurring problem is the failure to make a proper election for life estate property on the United States estate tax return.

3. COLLECTION OF THE KENTUCKY INHERITANCE AND ESTATE TAX. In the illustration for this paper, the bequest of the firearm collection could generate a tax. Will the executor collect the tax, before delivering the gun collection?

XX. WAIVER BY HEIRS.

In 1992, legislation proposed by the Legislation Committee of the Probate and Trust Law Section of the Kentucky Bar Association was adopted by the Kentucky General Assembly. It permits any fiduciary, prior to filing a final settlement and prior to distribution of assets, to file with the court a proposed written settlement. The settlement is set for hearing and noticed, as with other settlements. Beneficiaries of the estate are given notice by the fiduciary by certified mail of at least 20 days prior to the hearing date. In addition to all assets and disbursements previously made, the proposed settlement shall indicate assets on hand and "the manner in which the remaining and anticipated assets are proposed to be distributed."

An aggrieved party may "institute an adversary proceeding in Circuit Court" no later than thirty (30) days from the entry of the order upon the proposed settlement by the district court. (KRS 395.617(2))

The statute expressly states:

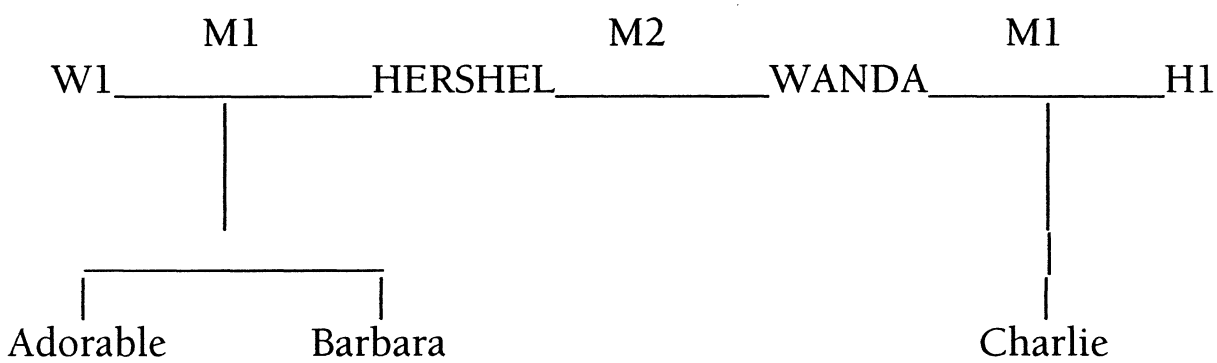
> Following the entry of an order of approval or of an order of amendment, the fiduciary shall disburse the assets in accordance therewith. KRS 395.617(1)

The statute purports to establish a waiver in the heirs of any objection to a settlement.

Glen S. Bagby
June 7, 2005

[Portions of this paper are from the author's chapter on "Spousal Rights" published by the University of Kentucky College of Law in its Handbook, *Kentucky Estate Administration*.]

HYPOTHETICAL FOR DISCUSSION



1. Hershel and Wanda were each married twice. They had children by the prior relationships indicated above.

2. After working for years in Texas, the couple moved to Kentucky to be nearer to their families.

3. There was no issue of their marriage to one another.

4. Upon their return to Lexington, the estate of Hershel's last surviving parent was being settled. The parent had owned outright 1,200 acres in Central Kentucky. There were three children, who agreed to partition the real estate into three 400 acre parcels. They hired a lawyer to draw the deeds of partition. The lawyer asked Hershel how he wanted to take title of the 400 acres he was to receive. Hershel told the lawyer to draft the deed to Hershel and Wanda, as joint tenants with right of survivorship. That deed was properly recorded in 1998.

5. Upon arrival in Kentucky, Hershel and Wanda paid cash for a new home on Richmond Road in Lexington, which turned out to have construction defects. They filed suit against the builder only months before Hershel's death.

6. Hershel had a very large cash inheritance, too. He placed it in two Certificates of Deposit with his two siblings, one-half in the name of each of his siblings, as joint tenants with right of survivorship.

7. For several years, Hershel needed assistance at home. His daughter was very helpful for quite a while during a very trying period. As a reward, Hershel deeded to Adorable 60 acres off the back of the 400 acres he received by the partitioned deed. He went to the lawyer who drafted the deed and the deed expressly provided:

EXHIBIT A

> It is expressly understood and agreed by the parties hereto that the conveyance of this land to the second party by the first party is not in the nature of an advancement from the first party to the second party, but is an absolute gift to her.

8. Later Wanda became concerned about Hershel's will and found in his papers a handwritten will leaving everything to Adorable. Wanda typed out a Codicil, which changed the residue clause to herself.

9. Also toward the end of his life, as his health worsened and his needs increased, Wanda became fed up with Hershel's demands and Adorable's presence. Wanda moved out. No divorce was filed, but by the time of Hershel's death, Wanda was living with a lover, out of the home.

10. When Hershel died, his holographic will dated January 1, 1998 read as follows:

    A. I name Adorable as my Executrix.

    B. I leave my personal property, outright, unto my wife, Wanda, if she survives me.

    C. I leave our residence on Richmond Road to Wanda for life, with the remainder upon her death to my children, Adorable and Barbara.

    D. All the rest, residue and remainder of my estate I leave outright to Adorable, my daughter.

    Also found was Hershel's typed codicil, which read:

    > I make this Codicil to my Last Will and Testament.
    >
    > I change Item D of my Last Will and Testament to read, "I give and bequeath the residue of my estate unto my wife, Wanda, if she survives me."

KENTUCKY BAR ASSOCIATION ETHICS OPINION E-401

The Committee has been asked to address the applicability of the Kentucky Rules of Professional Conduct with respect to a lawyer's representation of the fiduciary of a decedent's estate or trust, and the lawyer's responsibilities to the beneficiaries of estates and trusts. In order to provide the requested advice, explain the Committee's position on these issues, and to give insight into the applicable Rules of Professional Conduct, the following questions are presented for response and discussion.

Question 1: Does a lawyer's representation of a fiduciary of a decedent's estate or trust expand or limit the lawyer's obligation to the fiduciary under the Rules of Professional Conduct?

Answer: No.

Question 2: Does a lawyer's representation of a fiduciary of a decedent's trust or estate impose on the lawyer obligations to the beneficiaries of the decedent's trust or estate that the lawyer would not have toward third parties?

Answer: No.

Question 3: Is the lawyer's obligation to preserve client confidences under Rule 1.6 altered by the fact that the client is a fiduciary?

Answer: No.

Question 4: May the lawyer for the fiduciary also represent the beneficiaries of the decedent's trust or estate?

Answer: Qualified Yes.

References:
ABA Formal Op. 94-380 (1994); Privilege and Confidentiality Issues When a Lawyer Represents a Fiduciary, 30 Real Property, Probate and Trust Journal 541 (1996); ACTEC Commentaries on the Model Rules of Professional Conduct, 28 Real Property, Probate and Trust Journal 865 (1994); Developments Regarding the Professional Responsibility of the Estate Administration Lawyer: The Effect of the Model Rules of Professional Conduct, 26 Real Property, Probate and Trust

EXHIBIT B

Journal 1 (1991); When Loyalties Collide: Courts Resolve Conflicting Duties, 135 Trusts & Estates 22 (1996); Professional Responsibility Issues Keep Practitioners on Their Toes, 135 Trusts & Estates 22 (1996); and The Fiduciary, His Counsel And The Attorney - Client Privilege, 136 Trusts & Estates 29 (1997); §73, Duty to Certain Non-Clients, Restatement, The Law Governing Lawyers.

OPINION

From time to time Kentucky lawyers have requested advice from the Committee regarding a lawyer's responsibilities in the context of the administration of trusts and estates. The primary problem in answering such questions arises from the fundamental question: Whom does the lawyer represent? Does the lawyer represent the beneficiaries of the estate or trust; does the lawyer represent the estate or trust entity or does the lawyer represent the fiduciary? The complexity of this problem is acknowledged in Comment 12 to Rule 1.7, which states:

> Conflict questions may also arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may arise. In estate administration the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. The lawyer should make clear the relationship to the parties involved.

By issuing this Opinion it is the Committee's intent to clarify a Kentucky lawyer's obligations under the Rules of Professional Conduct. The examination of these issues must focus on Rule 1.7, Conflict of Interest: General Rule, and the problems generated by a lawyer's multiple representation of clients. The American College of Trust and Estate Counsel, hereafter referred to as "ACTEC," adopted Commentaries to the Model Rules of Professional Conduct in October 1993, and their Commentaries and the Reporter's Notes on the ACTEC Commentaries are helpful to this analysis. The Reporter's Notes contained the following statements:

> Lawyer for Fiduciary.
> Under the majority view, a lawyer who represents a fiduciary ... stands in a lawyer-client relationship with the fiduciary and not with respect to the fiduciary estate or the beneficiaries.
> Duties to Beneficiaries.
> The lawyer who represents a fiduciary generally is not usually considered also to represent the beneficiaries. However, most courts have concluded that the lawyer owes some duties to them. Some courts subject the lawyer to the duties because the beneficiaries are characterized as the lawyer's "joint," "derivative" or "secondary" clients. Other courts do so because the lawyer stands in a fiduciary relationship with respect to the fiduciary, who, in turn, owes fiduciary duties to the beneficiaries. The duties, commonly called "fiduciary duties," arise largely because of the nature of the representation and the relative positions of the lawyer, fiduciary, and beneficiaries. However, note that the existence and nature of the duties may be affected by the nature

> and extent of the representation that a lawyer provides to a fiduciary. Thus, a lawyer who represents a fiduciary individually regarding a fiduciary estate may owe few, if any, duties to the beneficiaries apart from the duties that the lawyer owes to other nonclients.

In addition to the Reporter's Notes, this Committee finds the following comments from the ACTEC Commentaries on Model Rule 1.7 instructive for purposes of clarifying the lawyer's obligations to the fiduciary, to the beneficiaries of an estate or trust, and the problems of multiple representation.

> <u>General Nonadversary Character of Estates and Trusts Practice: Representation of Multiple Clients.</u> It is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate plans, more than one beneficiary with common interests in an estate or trust administration matter....
> In some instances the clients may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. ... Multiple representation is also generally appropriate because the interests of the clients in cooperation, including obtaining cost effective representation and achieving common objectives, often clearly predominate over their limited inconsistent interests. ...
> <u>Disclosures to Multiple Clients</u>.
> Before, or within a reasonable time after, commencing the representation, a lawyer who is consulted by multiple parties with related interests should discuss with them the implications of a joint representation (or a separate representation if the lawyer believes that mode of representation to be more appropriate and separate representation is permissible under the applicable local rules). In particular, the prospective clients and the lawyer should discuss the extent to which material information imparted by either client would be shared with the other and the possibility that the lawyer would be required to withdraw if a conflict in their interests developed to the degree that the lawyer could not effectively represent both of them. The information may be best understood by the clients if it is discussed with them in person and also provided to them in written form, as in an engagement letter or brochure.

This Committee adopts the ACTEC Commentaries because the Commentaries properly set forth a lawyer's ethical obligations. Further, this Committee agrees with ABA Formal Opinion 94-380, and adopts the majority view; that is, that a lawyer who represents a fiduciary does not also represent the beneficiaries. We reject the view that a lawyer who represents a fiduciary also owes fiduciary obligations to the beneficiaries that in some circumstances will override obligations otherwise owed by the lawyer to the fiduciary, such as the obligation of confidentiality. We also reject the view that when a lawyer represents a fiduciary in a trust or estate matter, the client is not the fiduciary, but is the trust estate. We adopt the following comments made in the ABA's Formal Opinion:

> When the fiduciary is the lawyer's client all of the Model Rules prescribing a lawyer's duties to a client apply. The scope of the lawyer's representation is defined by and limited by Model Rule 1.2. The lawyer must diligently represent the fiduciary, see Model Rule 1.3, preserve in confidence communications between the lawyer and the fiduciary, see Model Rule 4.1(a). The fact that the fiduciary client has obligations toward the beneficiaries does not impose parallel obligations on the lawyer, or otherwise expand or supersede the lawyer's responsibilities under the Model Rules of Professional Conduct. A lawyer's duty of confidentiality to a client is not lessened by the fact that the client is a fiduciary. Although the Model Rules prohibit the lawyer from actively participating in criminal or fraudulent activity or active concealment of a client's wrongdoing, they do not authorize the lawyer to breach confidences to prevent such wrongdoing.

The ABA's Opinion, in Footnote 6, included the following important caveats:

> 6. The Model Rules impose a number of limitations on a lawyer representing a fiduciary. For example, a lawyer may not participate in a breach of fiduciary duty by the fiduciary that involves fraud or criminal activity because the lawyer's conduct is limited by Model Rule 1.2(d), which provides that a lawyer may not actively participate in a client's criminal or fraudulent activity. This rule applies to all lawyers, not just those representing fiduciaries. Lawyers are also prohibited from actively concealing client breaches of fiduciary duty, or actively assisting in such concealment, by Model Rules 4.1(a) (a lawyer shall not lie to third parties) and 3.3(a)(1) and (2) (a lawyer shall not lie to or conceal information from a tribunal).
> If a lawyer knows that a breach of fiduciary duty has occurred, and that an accounting is misleading in that it hides wrongdoing committed by the fiduciary, the lawyer is expressly prohibited by Model Rule 3.3(a) from presenting the accounting to the court. Further, the lawyer is prohibited by Model Rule 4.1(a) from representing to the beneficiaries that a false accounting is accurate. These rules apply to a lawyer with a fiduciary client to the same extent as, but no farther than, they apply in any other lawyer/tribunal/third party scenario.

Continuing in the text of the Opinion, the ABA Ethics Committee then made the following comments:

> Although a lawyer may not disclose confidences of the fiduciary, if the fiduciary insists on continuing a course of fraudulent or criminal conduct, the lawyer may be required to terminate the representation because the lawyer's services will be involved in that conduct, so as to invoke Rule 1.16(a)(1), or may have the option of a voluntary withdrawal under Rule 1.16(b)(1).
> If either of these provisions of Rule 1.16 applies, this will be not because the client is a fiduciary, but because the client is acting in the manner described by the Rule. The client's status is irrelevant.

Based upon the instructive comments of the ACTEC Commentaries and the ABA Formal Opinion, this Committee concludes with the following advice for Kentucky lawyers.

1. In representing a fiduciary the lawyer's client relationship is with the fiduciary and not with the trust or estate, nor with the beneficiaries of a trust or estate.

2. The fact that a fiduciary has obligations to the beneficiaries of the trust or estate does not in itself either expand or limit the lawyer's obligations to the fiduciary under the Rules of Professional Conduct, nor impose on the lawyer obligations toward the beneficiaries that the lawyer would not have toward other third parties.

3. The lawyer's obligation to preserve client's confidences under Rule 1.6 is not altered by the circumstance that the client is a fiduciary.

4. A lawyer has a duty to advise multiple parties who are involved with a decedent's estate or trust regarding the identity of the lawyer's client, and the lawyer's obligations to that client. A lawyer should not imply that the lawyer represents the estate or trust or the beneficiaries of the estate or trust because of the probability of confusion. Further, in order to avoid such confusion, a lawyer should not use the term "lawyer for the estate" or the term "lawyer for the trust" on documents or correspondence or in other dealings with the fiduciary or the beneficiaries.

5. A lawyer may represent the fiduciary of a decedent's estate or a trust and the beneficiaries of an estate or trust if the lawyer obtains the consent of the multiple clients, and explains the limitations on the lawyer's actions in the event a conflict arises, and the consequences to the clients if a conflict occurs. Further, a lawyer may obtain the consent of multiple clients only after appropriate consultation with the multiple clients at the time of the commencement of the representation.

9/97

8/10/84

You have requested an Opinion relating to the propriety of joint representation in the contexts of "no-fault" divorce and the preparation of antenuptial agreements.

Question 1: May an attorney ever represent both sides in a "no-fault" divorce?

Answer: Except in rare cases, No.

Question 2: If not, is it proper for the attorney representing one spouse to "talk with" the other spouse and "answer questions."

Answer: Qualified No.

Question 3: May an attorney represent both parties to an antenuptial agreement?

Answer: Qualified Yes.

Question 4: If not, is it proper for the attorney representing one spouse to "talk with" the other spouse and "answer questions."

Answer: Qualified No.

Opinion

The questions presented address the conduct of counsel in his or her traditional roles as advocate and advisor. In responding to these questions we do not address the propriety of mediation or arbitration in which the lawyer does not "represent" either party. Compare EC 5-20 and ABA Model Rule 2.2.

As you note in your request, the practice of both husband and wife going to see a single attorney to secure a dissolution of their marriage pursuant to the "no-fault" divorce act is not uncommon. You note that "where the parties have spoken with one another and desire an amicable divorce, it is also not uncommon for both parties to want one attorney to assist them in securing their desired divorce and in preparing what they believe to be their agreement." In such circumstances the potential clients may believe that having more than one lawyer is a wasteful luxury, and might even serve to exacerbate problems rather than solve them. Morgan, The Evolving Concept of Professional do not affect the right to negotiate with the unrepresented party. They merely preclude the attorney from giving advice to the unrepresented party"); Connecticut Op. 27 (1976) [Maru doc. 10700] (". . . if the other spouse has an independent opportunity to examine and approve the agreement before it is entered."); Florida Ops. 1-2 (1972) [Maru doc. 8126]; L.A.Co.Op. 334 (1973) [Maru doc. 7689].

<u>The question you ask is deceptively simple</u> -- may the attorney representing one party "answer questions" posed by the unrepresented spouse? Give the above authorities, and the fact that much legal "advice" is given in the form of answers to questions, the answer would be no in many, if not in most, instances involving more than the conveying of innocuous information or responses to simple questions. If the interests of the spouses are sufficiently conflicting to require separate counsel in the first instance, it follows that the door should not be opened that would allow the "answering of questions" concerning the effect of the proceeding on the rights or alternatives of unrepresented spouse. Counsel can be an "advocate for or an advisor to only one of the contesting parties." New York Op. 478, supra.

Regarding antenuptial agreements, we note that separate ethical problems may be presented if the particular agreement could be construed to violate public policy. In Jackson v. Jackson, 626 S.W.2d 630 (1981) the Supreme Court cited with approval the following language from R. Petrilli, Kentucky Family Law § 13.8:

> ". . . Public policy embraces a vital interest in the preservation of marriage. Any provision that looks toward, provides for, facilitates, or tends to induce a separation or divorce after marriage is contrary to public policy and void. A provision for the payment of alimony or a property settlement should a separation and divorce occur after marriage is void and unenforceable . . . ." Kentucky Family Law, Husband and Wife, Sec. 13.8.

See also, Sousley v. Sousley, 614 S.W.2d 942 (1981); Stratton v. Wilson, 185 S.W. 522 (1916). Compare New York City Op. 722 (148) (A lawyer may not insert in contracts provisions which have been held void against public policy by "a court of last resort . . . as a matter of law.").

Assuming that the agreement contemplated by the parties does not offend public policy, joint representation may threaten the exercise of counsel's independent professional judgment if one or the other of the parties is unwilling to be completely forthcoming. Specifically, we note another passage from Petrilli, at § 13.5:

> During marriage, or after the death of one spouse an antenuptial agreement may be avoided unless . . . [both parties have] knowledge . . . of their legal rights, and knowledge of the effect the antenuptial agreement will have upon their legal rights.

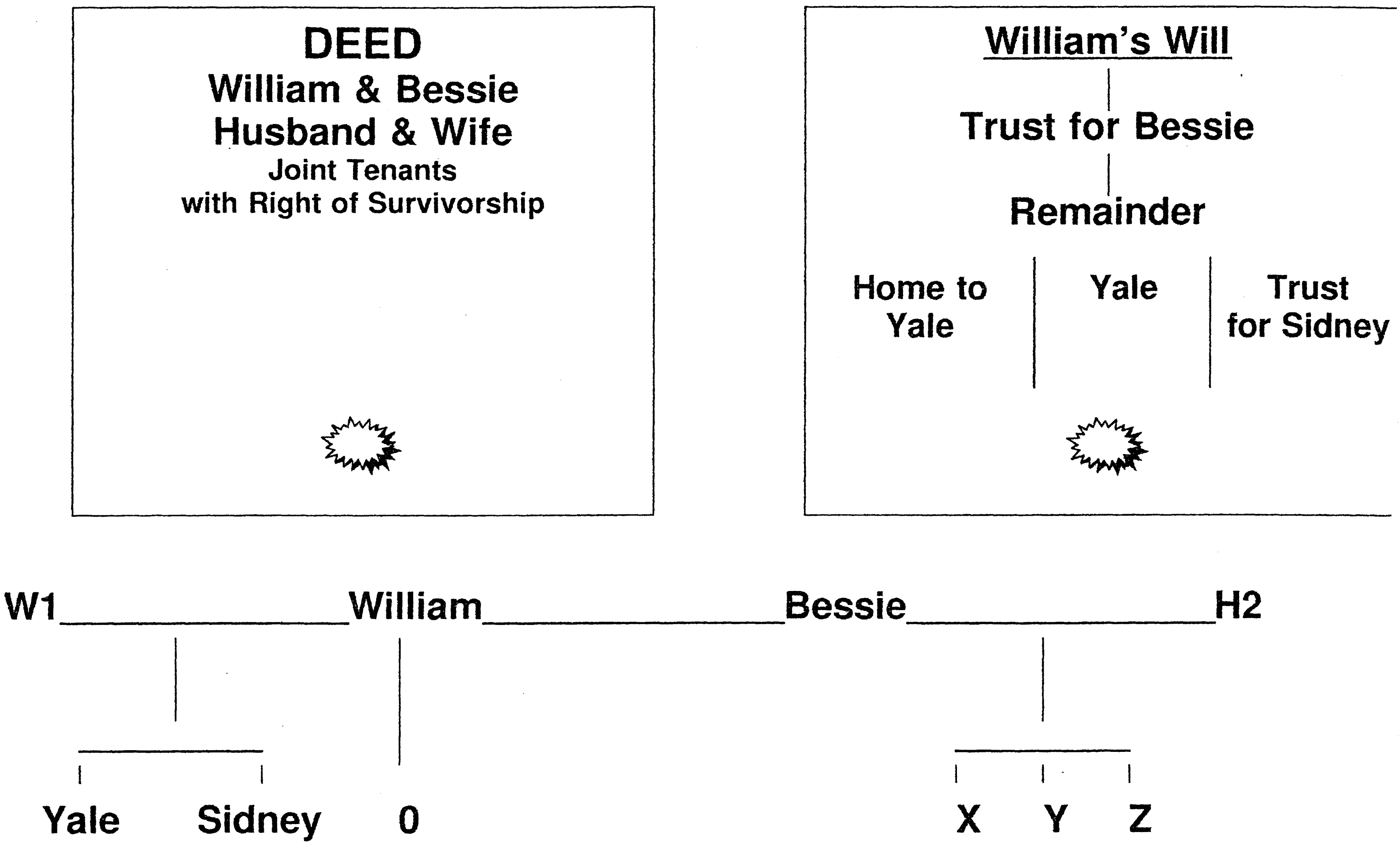
Elsewhere in the same section the author observes that "full frank disclosure to each other of the property held by each of them" is required, and that "it is good practice to make a recital in the antenuptial agreement of the parties holdings of property." Compare Lipski v. Lipski, 510 S.W.2d 6 (1974) (upholding antenuptial agreement prepared by an attorney representing both parties). If counsel is possessed of confidences or secrets of a party that the other needs to know and that party is not willing to disclose such information, it is obvious that counsel would, at the very least, violate DR 5-105 by purporting to represent both.

Accordingly, joint representation should be undertaken only if each party consents to the representation after full disclosure of the potential problems inherent in such representation. Prudent counsel would obtain such consent in writing. DR 5-105(C).

Finally, we believe that our comments in response to Question 2 are pertinent to Question 4.

Richard H. Underwood
Chairman, Ethics Committee

KENTUCKY TRUST COMPANY V. KESSELL
Ky. 464 S.W.2d 275 (1991)
[THE DOCTRINE OF TESTAMENTARY ELECTION]

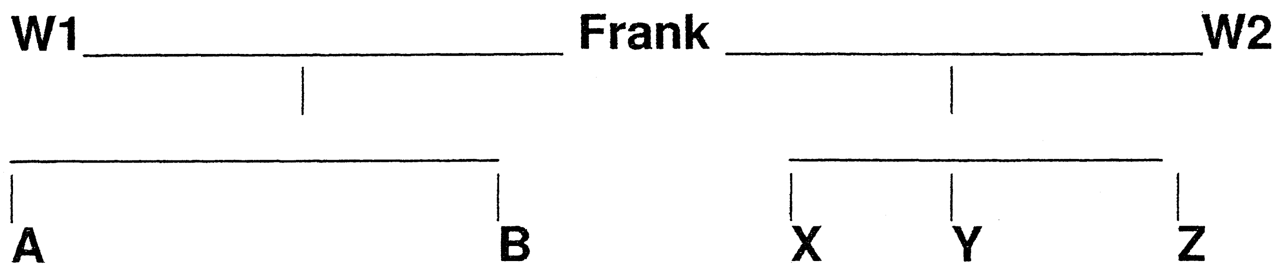


TRACE/PRESERVE JOINT TENANCY -- VS-- TERMINATE
KRS 381.050

EXHIBIT D

<u>ECTON V. FLYNN</u>
229 KY 476, 17 S.W.2D 407 (1929)
ADVANCEMENTS/THE DOCTRINE OF HOTCHPOT

110 Acres

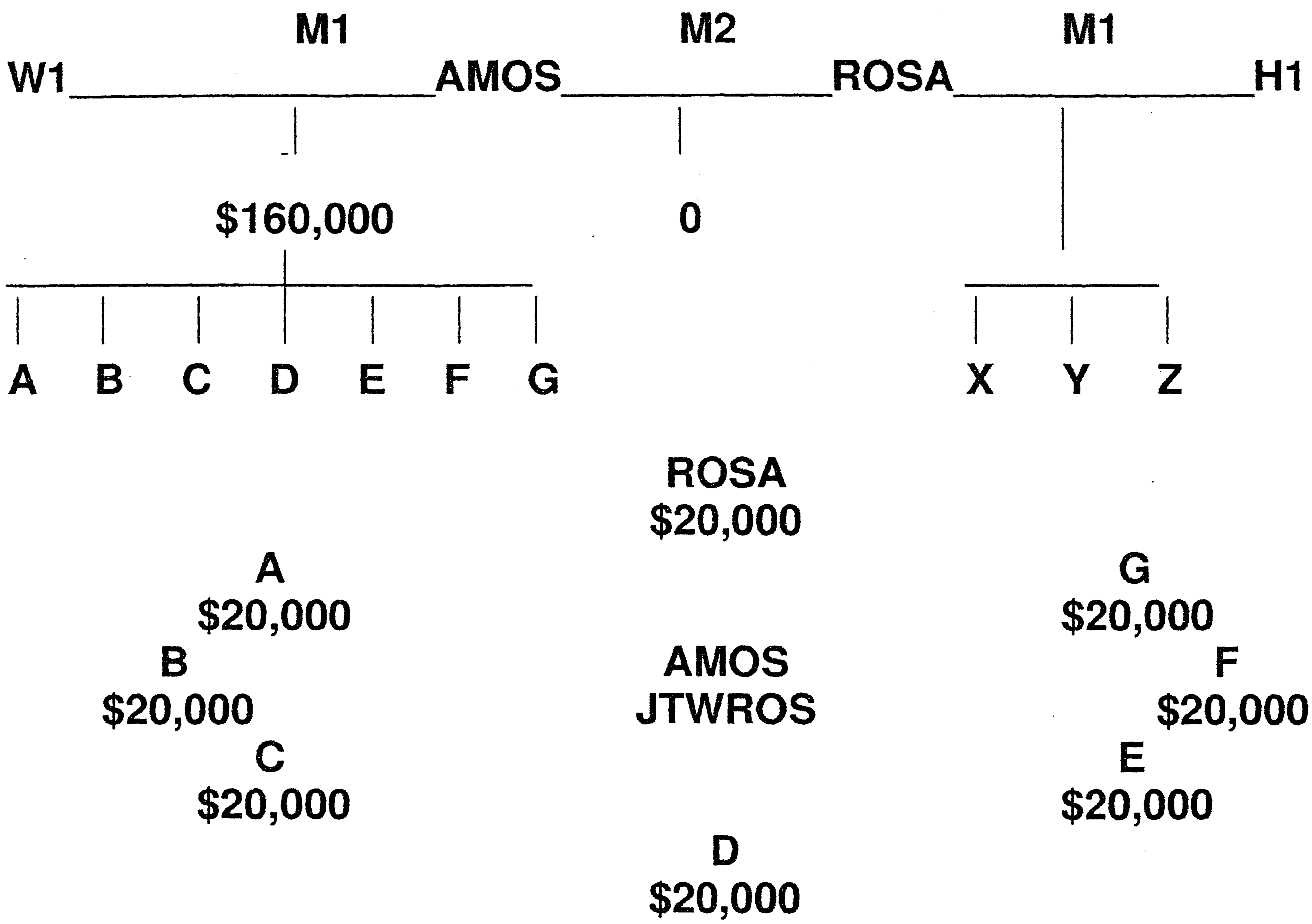


DEED
Frank
Love & Affection
to
X Y Z
50 Acres

"It is expressly understood and agreed by the parties hereto that the conveyance of this land to the second parties by the first party is not in the nature of an advancement from the first party to the second parties, but is an absolute gift to them."

FRANK DIES INTESTATE
DOES DEED HOLD UP?

EXHIBIT E



1. Apparently, Amos had $160,000 from first marriage.

2. Amos creates $20,000 CD's with second wife (Rosa) and seven children by first marriage.

3. Amos dies.

<u>Harris v. Rock</u>, Ky., 799 S.W.2d 10 (1990)

EXHIBIT F

DECONSTRUCTING TRUSTS

Wayne F. Wilson
Goldberg & Simpson, P.S.C.
Louisville, Kentucky

SECTION F

DECONSTRUCTING TRUSTS
A Practical Approach

DECONSTRUCTING TRUSTS
A Practical Approach

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I. Framing the Issue (WFW's Disclaimer)

A. To the client, a trust comes with burdens, both real and merely perceived. Many people who establish trusts see them as a necessary evil; something their lawyer made them do to avoid taxes, take care of minor children, take care of a spendthrift, or protect an inheritance for children from a prior marriage.

B. This outline is intended to address the issue of deconstructing trusts from the Settlor's point of view, not the beneficiary. Where there is a trust, there is a beneficiary who would like to "break" it and those methods are not addressed here.

C. This outline is not intended to serve as a scholarly work or academic commentary. Furthermore, this outline does not address the myriad of tax issues presented by unwinding funded trusts. This outline is a collection of some of the practical, if imperfect, methods that have been employed to unwind funded trusts.

D. Ultimately, your ability to take apart a trust will turn on the provisions of the trust instrument. I have found that by studying the instrument carefully, there is almost always a way.

E. This entire outline is based on the premise that the contemplated technique to be employed has the full support of all interested parties. This is the first and most important step in the process. Without full support of all involved, there is little point in proceeding.

E. A LAWYER WHO ASSISTS WITH THE TERMINATION OF A TRUST ALWAYS RUNS A RISK OF HIS WORK BEING SECOND GUESSED BY TRUSTEES, BENEFICIARIES AND POSSIBLY THE COURT. CHOSE YOUR CLIENTS CAREFULLY

II. Funded Revocable Living Trusts

A. This is the easiest type of Trust to unwind because its terms allow for its revocation. However, I often counsel clients against revoking their funded revocable trusts even if the reasons for the trust have gone away. This is because the administrative cost of "un-funding" a living trust can outweigh its benefit. It may be much more cost effective to revoke most of the provisions of a living trust and substitute language that directs an outright distribution at the Settlor's death.

B. My biggest fear with unwinding a funded living trust is that I will deliver what I think are all the assets out of the trust and then revoke it, only to discover another asset once the Trustee has lost all authority, or worse. The bottom line is that you can't always trust your client to advise you of all the assets that have been placed in the trust; especially if you aren't the lawyer who initially drafted and funded the trust. Revocable trusts don't file tax returns so it can be hard to back into the assets. There could also be real property held in the trust you aren't aware of.

III. Terminating Trusts by Statute or by the Terms of the Instrument

A. KRS 386.185 allows a trustee administering an amount of $25,000 or less to distribute the trust assets to the beneficiary. The Court MUST enter the Order distributing the funds and releasing the Trustee. The statute goes on to state that the recipient of the trust proceeds "shall be under a duty to use the funds for the purpose of the trust."

B. Although not technically a termination, KRS 395.326 states that a testamentary trustee serving under a Will which does not nominate a successor trustee, may designate his own successor trustee. The statute requires a hearing with notice to the beneficiaries. If the desire is to "free up" the trust assets, the proper successor trustee will likely be the current beneficiary.

C. Sometimes a trust instrument will contain language that states that a trustee, usually a corporate trustee, can terminate a trust when:

1. The trustee determines the trust can no longer be economically administered; or

2. The trust assets are no longer sufficient to generate the trustee's minimum fee.

D. If a trust instrument contains language which allows the trustee to terminate it, it usually directs the trustee to distribute the assets to individuals who are currently eligible for income distributions.

IV. Merger of Estates (not to be confused with a qualified disclaimer)

A. The Internal Revenue Code and the KRS both provide for qualified disclaimers which will avoid the imposition of transfer tax from one beneficiary to the next. Luckily, this outline is not about taxes.

B. The principal behind "qualified" disclaimers is fundamental; a would-be beneficiary doesn't have to accept an interest in trust. Even if the interest is accepted, it can be relinquished and transferred.

C. Generally, a beneficial interest in trust may be transferred. Where the current beneficiary transfers his interest to the remainder beneficiary, it is said that a "merger of estates" has occurred and the trust may be terminated. Where a current beneficiary's interest has been accelerated, the interest will become the sole estate of the remainder beneficiaries.

1. While the doctrine of Merger of Estates is covered at length by the usual treatises and the Restatement of Trusts, there is little Kentucky law on the subject, but see, *In re Klayer, 20 B.R. 270.*

D. There are a number of issues which may arise when trying to terminate a trust under the doctrine of Merger of Estates:

1. Does the instrument prevent the beneficiary from alienating his interest? If so, all may not be lost since a spendthrift clause should not be interpreted against the remainder beneficiary of trust and since the transfer is voluntary.

2. There is some authority that for a trust Merger of Estates to occur the current beneficiary, remainder beneficiary AND TRUSTEE must all be one and the same. Therefore, a third party trustee must be willing to participate.

3. There is some authority that once a trust is funded, a merger of estates does not terminate the trust but only makes it terminable by the new, sole beneficiary. Thus, a shade of gray which could necessitate a court action depending on the willingness of the trustee to participate.

4. If any of the above issues are present, a decision will have to be made as to whether the trust estates should be merged without the approval of the court.

V. Merger of Instruments

A. Though not technically a termination, merging one instrument with the other can accomplish a kind of deconstruction. Often, an attempt to accommodate a client's wish to terminate a trust is to make the best of a bad situation. In such a case, merging one offensive instrument for a less offensive instrument may present the best, and most cost effective, option for the parties.

B. Many trust instruments provide that a Trustee has the authority to "merge the assets of this trust with those of any other trust with similar provisions so as to allow the Trustee to hold the assets of all of such trusts as one single trust."

or

"The trustee may merge or consolidate any trust into any other trust that has the same trustee and substantially the same dispositive provisions."

C. As with every other technique covered here, merging two instruments is an imperfect art and should not be undertaken without an examination of all the issues which could affect the beneficiaries:

1. What does "substantially the same" really mean?
2. What if one trust contains a merger provision but the other does not?
3. Which trust will be the survivor instrument?
4. Can two trusts which do not contain merger provisions still be merged absent court approval?

VI. Termination by Agreement

A. It is well settled in Kentucky that even if a Trust is irrevocable, it can be rescinded with the consent of the settlor and all the beneficiaries or upon a showing that the trust is a product of fraud, duress, undue influence or mistake. *Cruise v. Leary, Ky.App., 727 S.W.2d 408 (1987).* There are several published cases which expand on this statement and some that appear to limit it. The following represents a fair survey:

1. A trust may be terminated by agreement of all parties in interest, by consent of beneficiaries upon any judicial action, where instrument creating it does not in express terms or by necessary implication prohibit termination thereof, or by mere consent of beneficiaries alone, if object of plan of trust is not defeated, or trust res is not diverted from essential purpose of trust. *First Nat. Bank & Trust Co. of Lexington v. Purcell, Ky., 244 S.W.2d 458 (1952).*

2. Chancellor's consent is unnecessary to terminate trust as to either life tenants or remaindermen when all of them are living and sui juris. *Keith v. First Nat. Bank & Trust Co., Ky., 75 S.W.2d 747 (1934).*

3. A Court of equity may not terminate a trust, even though interested parties agree to terminate it, unless design and object of trust has been accomplished. *Young v. Robinette, Ky., 239 S.W.2d 91 (1951).*

4. To terminate trust agreement in which no power of revocation is reserved in absence of fraud or mistake, whole object trust must have been accomplished, termination of trust must be advantageous to beneficiaries, and all interested parties must consent. *Fidelity & Columbia Trust Co. v. Williams, Ky., 105 S.W.2d 814 (1937).*

B. The first two cases cited above invite lawyers to terminate trusts by Agreement. The second two appear to dare lawyers to terminate trusts by Agreement. The common threads appear to be the participation of all interested parties/beneficiaries and the accomplishment of the trust purpose (or at least the lack of its defeat).

1. It's a sure bet that the participation of all beneficiaries includes both income and remainder beneficiaries. Since this is the case, and if the remainder succession is contingent upon surviving the life tenant, how can "all" beneficiaries participate in the trust's termination by agreement when we don't yet know who the remainder beneficiaries are?

2. There is little published guidance on what it means to say that a trust's purpose has been accomplished, or at least not defeated. Generally, I tend to look for language in a trust that appears to espouse a clear purpose such as, until my child attains the age of 35; this is a clear trust purpose that cannot be evaded.

C. Clearly, there is case law that supports the proposition that a trust can be terminated by agreement among the parties. The question then becomes whether the matter is "clean" enough to be resolved without a court saying grace over it and whether the client can be protected without a court order.

VII. Judicial Termination

A. There is both comfort and risk in attempting to dismantle a trust through judicial termination. There is comfort in knowing that whatever the outcome, it was upon the orders of the court and all was done within the bounds of fiduciary prudence. Of course, the risk is that you won't get what you want.

B. The strict legal justification for terminating a trust has been summarized in the preceding section. However, the case of *Kelly v. Marr* must also be mentioned as it stands for the proposition that where there has been a change of circumstances not known to or anticipated by settlor and such circumstances would defeat or substantially impair accomplishment of purposes of trust, the court may direct the trustee to do acts forbidden by terms of the trust. *Ky., 185 S.W.2d 945 (1945).*

1. When asking a court to deviate from or terminate a trust, the most common averment is that the trust was entered into by a mistake of some kind or that circumstances have changed which could not have been foreseen by the settlor.

2. While the above case does not support trust termination, it does support a judicial modification and, as mentioned earlier, when making the best of a bad situation, sometimes a less offensive trust instrument presents the best option for all the beneficiaries.

C. Jurisdiction and Venue

1. Statutes

a. KRS § 24A.120 – Jurisdiction of District Court
b. KRS § 386.675 – Initiation of Judicial Proceedings
c. KRS § 386.680 – Venue

2. Cases

a. *Lee v. Porter, Ky. App., 598 S.W.2d 465 (1980)*
b. *Vega v. Kosair, Ky. App., 832 S.W.2d 395 (1992)*

3. Necessity of GAL

a. *Whallen v. Kellner, Ky. App., 104 S.W. (1907)*

MEDICAID ELIGIBILITY & PLANNING TECHNIQUES

Brian Borellis
Attorney at Law
Louisville, Kentucky

SECTION G

MEDICAID ELIGIBILITY & PLANNING TECHNIQUES

MEDICAID ELIGIBILITY & PLANNING TECHNIQUES

by

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PART ONE: ELIGIBILITY RULES

A. OVERVIEW

1. The Statutory regime

Medicaid financial eligibility requirements are codified generally within the maze of regulations set out within Title 42 of the United States Code, and Title 20 in the Code of Federal Regulations. The program is jointly administered by the Center for Medicare and Medicaid Services ("CMS") and local state governments. CMS has published the so-called State Medicaid Manual which provides guidance on the federal rules and policies pertaining to the Regulations.

In Kentucky, the Regulations pertaining to financial eligibility are generally set out at Chapter 907 of the Kentucky Administrative Regulations. The Kentucky Department for Medicaid Services ("DMS") is the primary agency responsible for implementation of the Medicaid program. DMS contracts with the Department for Community Based Services ("DCBS") which has generated a manual to provide guidance to caseworkers. This Manual, known as the Field Services Operation Manual (the "manual") contains very specific provisions as to how a particular set of facts should be interpreted in the context of Kentucky Medicaid eligibility. The manual may be accessed on the internet at http://manuals.chfs.ky.gov/dcbs_manuals/DFS/index_dfs.asp.

2. Why is it important to know about Medicaid?

Medicaid is the only program of governmental financial assistance by which an individuals' long term institutional care is paid. Medicare only pays in limited circumstances, and then for a limited period of time. In that nursing home expenses in Louisville currently approach an average of $5,000 per month, a basic understanding of these rules is an important component of any practitioners' knowledge to provide effective estate planning advice to elderly clients in anticipation of the need for long term care.

(a) 3 criteria for eligibility

Medicaid does not generally pay for personal care. Thus, in addition to meeting financial eligibility, the individual must ALSO meet the test for medically needy, and the care provider must agree to accept Medicaid.

Given the very substantial potential financial costs to our clients should they require institutional care, some basic appreciation for Medicaid eligibility is important whether for advance planning purposes or damage control.

B. THE ESSENTIAL RULES

1. Resource Limitations/ Transfer considerations

(a) Basic concept – Fitting within resource limitation

In that Medicaid, unlike Medicare, is a "means-tested" benefit, eligibility turns on the financial ability to pay for care. Thus, one must reduce his or her assets – known in Medicaid parlance as "resources" – to permissible limits. A fundamental component of Medicaid eligibility requires the would-be applicant to be within resource limits. For persons who require long term care – whether at home or in a facility- the limits are $2,000 of counted resources for a single person, and for a couple one-half (1/2) the counted resources, not more than $95,100 (and not less than $20,000) in 2005, and as adjusted in later years per COLAs.

(2) Excluded versus counted resources.

Before advising clients, one would do well to become familiar with the regulations concerning what is counted and what is excluded. Counted resources may be retained. Generally most liquid resources are counted with the notable exception of funds in a tax qualified retirement plan at least until withdrawn. See 907 KAR 1:645(3)(21).

(i) Note: Current policy requires withdrawals to be taken at age 591/2. Also, certain jointly owned resources may be excluded at least where the co-owner refuses to release his or her portion of the property. This is discussed in greater detail below.

Generally, most people who come to us for assistance will have resources in excess of the limitations, and are eager for guidance as to how they may properly fit within the limitations. As the material in Part Two, below, will illustrate a number of means by which an individual may re-structure resources, in the overwhelming majority of cases one of the first steps is to look at whether an outright transfer of resources so as to reduce funds to resource limitations is advisable.

As is true in many other areas of the law (e.g., contemplation of death gifts in the context of estate/inheritance tax) divestiture of assets as a means of re-writing one's financial statement in anticipation of gaining advantages due to a post-divestiture net worth is subject to scrutiny. Stated differently, transfers made in contemplation of gaining Medicaid eligibility will be subjected to a penalty.

(b) The transferred resource rule - Funds transferred for less than fair market value (gratuitous transfers) to the recipient will trigger a penalty which is expressed in terms of an ineligibility period, or length of time from date of gratuitous transfer until the transferor may become eligible for benefits.

(1) Transfers considered - There is a 36 month "look-back rule" which establishes the time parameters during which transfers are considered. The look-back period extends to 36 months for outright transfers preceding the month an individual is institutionalized and an application for Medicaid is made. For most transfers to trust, the look-back is increased to 60 months from the date all, or a portion of, the trust becomes unavailable to the transferor.

(2) Transfer penalty calculation

Once a transfer is made for less than fair value during the look-back period, a transfer penalty is assessed. Each transfer is assessed a penalty in a process by which the transfer is divided by the so-called "transferred resource factor" in the year of Medicaid application. In 2005, in Kentucky, that is $2,685. The transfer factor changes from year to year based on cost of living adjustments, but the factor used by DCBS in considering a case is the factor in the year the application is made, NOT the year where the transfer is made.

SPECIAL NOTE: For transfers made which will trigger a penalty which will go into the second or third year after transfer year, this may shorten the waiting period a month or two. This is particularly so in years where the first transfer is made late in the year – November or December – and the sum *transferred is significantly close to 36 times the transfer factor of the current year.*

- Thus, a transfer of $26,000 is divided by $2,685, resulting in 9.683.
- Figures to right of decimal are disregarded.
- The result is the number of months of Medicaid ineligibility starting with and subsequent to the month of transfer, with the month of transfer being regarded as the first month.
- See Medicaid Manual Volume IVA, Section 2080(D) for illustrations, and examples of multiple transfers.
- Multiple transfers which do not trigger overlapping penalties are treated separately.
- Transfers made further back in time than the reach of the look-back period are generally irrelevant. Thus, were Oprah Winfrey to transfer billions to her children and retain nothing she could qualify for Medicaid in 3 years.

(c) Planning with (i.e.,timing) transfers- As indicated above, timing is – if not "everything" - certainly a significant factor. Thus, in planning gifts, transfers timing should be approached from various vantage points, the first of which may well be "what amount(s) and when" .

Transfers can take several different forms.

(1) Lump sum gifts – Typically, transfers of *all* resources are inadvisable since the larger the transfer the larger the penalty, and funds will be necessary to pay for the cost of care until the penalty expires and a Medicaid bed is available. Thus, transfer planning must take into account cost of care during the ineligible interval.

Example #1: Mother has $100,000. A transfer of all funds will mean that she will not be able to apply to be eligible for benefits for 3 years. Why? $100,000 divided by $2,685 = 37 months. In the meantime nursing home expenses will need to be paid.

(1) Rule of halves (with some adjustments). Instead of transferring $100,000, consider a gift of half. $50,000 divided by $2,685 will result in a transfer penalty of 18 months which will be paid from the $50,000 retained; that

would mean that $2,685 per month would be available to pay the facility from the retained funds until dissipated.

Since the $2,685 is a statewide average "Medicaid rate" and not a realistic private pay rate, and further since private rates will tend to average more along the lines of $5,000 per month, there will be an appreciable shortfall each month. The income of the nursing home patient will help defray the cost, but to what extent ? This must be factored in to the equation.

<u>Example #2.</u> Same facts as in Example #1, but to complete the picture, assume mother has $1,000 per month social security, and a $815 pension per month. Thus each month payment will be made on the following basis –

• Retained funds per transfer factor	$ 2,685
• Income	<u>1,815</u>
TOTAL	$4,500

Consideration of expenses and also income must be factored into determining the amount required, and it is wise to adjust the gift accordingly.

In the above example, this means that for 18 months – until the penalty expires – there will be a monthly shortfall of $500 per month, or $9,000.

(2) <u>Rolling transfers</u> - May shorten ineligibility period. For instance, a transfer of $5,500 per month will - in a year when the transfer factor is $2,800 - result in a 1.964, or 1 month, penalty. This is because penalties are based on whole numbers (recall that figures to the right of decimal are dropped).

Under current law, so long as the penalties do not overlap each transfer is considered separately. Thus, the ineligibility period with respect to a transfer of $22,000 may be shortened from the 7 months which would apply in the case of a lump sum transfer ($22,000 ÷ $2,800 = 7.85 or 7) to 4 months where the transfers are made consecutively rather than all at once ($5,500 ÷ $2,800 = 1.99, or a one (1) month penalty each month which begins, and expires, within the same month.

(3) Caveat – ALWAYS remember to inquire about gifts made during the look-back period. Transfer strategies which do not verify whether prior gifts were or were not made may backfire.

C. PLANNING FOR COUPLES – THE COMMUNITY SPOUSE ALLOWANCES

1. Background: Spousal Impoverishment

Until the passage of the Medicaid Catastrophic Coverage Act of 1988 (MCCA), in situations where one spouse was institutionalized (the "institutionalized spouse") and another spouse remained at home (or in the community, thus known as the "community spouse"), since the only financial resource exclusion was limited to $2,000 per spouse, the cost of care for an institutionalized spouse frequently brought about the impoverishment of not only the institutionalized spouse, but also the community spouse. Stated differently, the community spouse was required to contribute of his or her resources to support the institutionalized spouse until the resources of both spouses had been reduced to the exclusion amount for each.

The MCCA, however, provided some relief to the community spouse. Basically, the rules permitted the community spouse to retain a threshold level of assets – which since 1988 changes from year to year - in order to provide a financial cushion for that spouse. This same rationale remains prevalent both directly and indirectly in 2005, and the underlying philosophy permits the community spouse to request additional allowances and income even above the automatic resource allowance where he or she can demonstrate financial need.

2. Determination of Community Spouse RESOURCE Allowance

Prior to June 1, 2003, the Community Spouse Resource Allowance ("CSRA") in any given case was a fixed sum of money. In other words, the community spouse was permitted to keep a set dollar amount. Whatever the amount in a particular year, all that was necessary was to make sure that the counted resources were within limits, and once they were – assuming any relevant gift penalties have expired – the Medicaid application would be approved.

Sadly for the unprepared, those days of readily understandable guidelines are "gone with the wind" – the 2003 legislative revisionist wind. In 2005, determinations of the CSRA requires a more complex calculation which involves in all but very small estates (resources less than $20,000) a two step procedure.

(a) Resource assessment. The process of determining the CSRA is started with a so-called "resource assessment" which is a calculation done by the Medicaid caseworker on form Medicaid form MA-22. This will require scheduling a date with the Medicaid caseworker assigned to the particular facility, and submitting required documentation about current assets.

(1) Aggregate countable resources. All non-exempt resources of both spouses must be counted together, regardless of their character, and regardless of whose name appears on the title of the resources. Such non-exempt resources are pooled, and the total value is calculated.

(b) Segregate community spouse's allowable share. At the resource assessment the community spouse's CSRA is determined as follows:

(1) Effective June 1, 2003 in Kentucky the CSRA is a minimum of $20,000, or one-half of the value of the pooled counted resources, whichever is greater, up to a maximum – in 2005 - of $95,100.

(2) Both the base amount and the maximum is adjusted annually for federal cost of living adjustments as evidenced by the Consumer Price Index.

(i) NOTE: This does NOT mean that each year once Medicaid eligibility is established the spouse gets an increase. It simply means that the amount which will be set aside for the spouse *at the initial determination* changes for each year. See, however, paragraph (e) of this section, below, relating to post-eligibility accumulations for the community spouse.

(3) The other one-half of the spousal resources, or, if greater, the amount of those resources which exceed the CSRA maximum amount (in 2005 that is $95,100) count as resources of the institutionalized spouse, which will disqualify that spouse for Medicaid until either "spent down," that is, applied towards the cost of that spouse's care in the institution, converted to excluded resources, given away followed by the conclusion of the ineligibility period, or a combination of any of the above.

(4) Note that only counted resources are factored in to determine CSRA. Thus, for instance the residence, retirement plans and excluded vehicles of the spouses are not considered in determining the CSRA.

(c). Inter-spousal Transfers

Since the transfer of resource rules are not applicable with respect to transfers to or for the benefit of an individual's spouse, the institutionalized spouse (or his or her attorney-in-fact with sufficient authority to transfer resources on his or her behalf) may transfer resources to a community spouse without penalty in order to bring the community spouse up to the maximum CSRA allowance.

It should be noted that since October 1995 in Kentucky all resources owned by both spouses at the time the institutionalized spouse applies for Medicaid are counted even if there is a valid pre-nuptial agreement which purports to maintain assets for the exclusive use of the community spouse.

(d). Preserving the CSRA maximum under new rules.

Timing is not necessarily "everything" when it comes to maximizing the CSRA... to paraphrase Vince Lombardi, it is "the only thing", and since the practitioner on the field of legal football will determine whether the spouse wins the maximum allowance, it is incumbent upon us to know the rules.

(1) Two-step process.

(i) As stated above, the CSRA is now limited to 1/2 of counted resources, up to the maximum in the year the application is made Thus, if spouses own $90,000 when application is made, the CSRA is $45,000. The institutionalized spouse may keep $2,000, and thus the couple exceeds limits by $43,000.

In all cases where the couple has more than $20,000, there will be a potential eligibility problem unless a resource assessment precedes the Medicaid application to establish the amount of resources, set the CSRA, and determine excess resources which must be spent, transferred or converted by the time the application is made.

(ii) Thus, there are two steps to administrative process:

a) First, it is necessary to e*stablish the CSRA*. This is done at the time of the resource assessment. Once locked in to the amount of the CSRA, the next task involves reducing the spouse to be within the limits so that at a later date, when the second administrative procedure – the application for Medicaid eligibility – is undertaken, the institutionalized spouse qualifies.

b) That second step is when the actual *application for benefits is* made.

Example: Husband, in LTC facility and his wife who lives at home have $200,000 in counted resources. Resource assessment is done in August 2005 and $95,100 set aside as the CSRA for the Wife. Spend down plan/gifting/conversion of counted resources into excluded resources or income takes place. When the community spouse's assets are within the CSRA, and the institutionalized spouse is within $2,000 limit, the application should be approved.

(2) Planning in light of the procedures –

(ix) Maximize resources at time of assessment .In that the amount of the CSRA will depend on the assessment, and in view of the fact that the assessment is done on the basis of counted resources, consider legitimate means of maximizing counted resources at time of assessment.

a) Have assessment done when resources are at high point; e.g before gifting; spending.

b) Where funds will be available, or MAY be available, have assessment done when they are in hand.

c) Query: can you borrow to increase resources when otherwise would have less than the maximum times two?

Example: Where counted resources are less than two times maximum ($95,100, in 2005) an assessment will produce less than the maximum. If spouses have $150,000, the maximum CSRA would be $75,000. Can spouses borrow another $40,200 so that when assessment is done their resources stand at $190,200? This would yield a CSRA of $95,100. Once the CSRA is set, the loan could be repaid.

d).What about withdrawing principal from IRA more rapidly to increase counted resources?

(e) Post eligibility excesses.

It should be noted that under present policy with the month starting *after* the month in which Medicaid eligibility is established as to the institutionalized spouse, the resources of the community spouse are no longer considered. Thus, once the institutionalized spouse is Medicaid eligible, should the community spouse acquire additional resources, the community spouse will not be required to contribute such excess resources towards the cost of care of the institutionalized spouse unless the institutionalized spouse goes off Medicaid and a new application is made.

3. Income rules between spouses – The Community Spouse INCOME Allowance

Since the MCCA was enacted, the community spouse has been permitted to retain not only more substantial assets, but also a much higher level of income. Basically, the income of the community spouse is no longer required to be used to help pay for the cost of care of the institutionalized spouse. Unlike the rule with respect to assets, the income of each spouse is considered owned by the spouse in whose name it is paid. Income paid in both names is considered to be owned by each spouse as to one-half of the amount of such income.

(a) Community spouse's income stays with him or her. The community spouse may keep all his or her income regardless of amount.

(b) Automatic allowance from institutionalized spouse to community spouse. The community spouse may draw against the institutionalized spouse's income (which may include the institutionalized spouse's Social Security) to the extent necessary in order to bring the community spouse's income up to the annual allowance, which starting in July 2005 is $1,604.

(c) Additional automatic allowance – excess shelter expenses. In situations where the community spouse has regular and significant monthly "shelter expenses", the CSIA may be increased by the Medicaid caseworker on the basis of clear documentation of same. The "shelter expenses" are expenses necessary to maintain the "roof over the spouse's head" and do NOT include personal living expenses such as groceries, spousal medical expenses, and similar items. Basically what is involved here are such monthly expense items as rent, mortgage, homeowner's insurance, utility expenses, and a limited amount - $30 – for telephone.

(1) Note: Only the EXCESS shelter expenses are allowable – that portion of such items in excess of a shelter standard of, in year 2005, $482 per month.

<u>Example:</u> Assume that shelter expenses come to $782 per month. The extra $300 is added to the $1,604 allowance. Thus, the community spouse will be permitted to draw on the institutionalized spouse's income to bring her income up to $1,904 per month.

(2) Clear documentation such as bills, receipts, should be presented the Medicaid caseworker to substitute the amounts.

(d) <u>Court ordered/fair hearing additional allowances</u>
The federal and Kentucky regulations recognize situations where the community spouse may need additional income allowances, and provides for same through either an appeals hearing or court order. Such allowances require either administrative award beyond the caseworker level, or judicial process.

D. THE HOMESTEAD (PERSONAL RESIDENCE) IN THE WAKE OF 9-1-03 RULES

1. <u>Overview</u>

(a) <u>Former law</u>. Under law in effect prior to September 1, 2003, the homestead was not counted as a resource. This was true regardless of whether the Medicaid recipient could ever be expected to return home, and in fact whether he or she ever even set foot in the home. Under pre-September 1 rules, excess resources could be used to improve or buy a bigger residence, and thus converted into an excluded resource.

2. <u>Post-August 31, 2003 Rules</u>

(a) <u>Homestead may need to be sold</u> Under new rules, unless the property is resided in by a spouse or dependent family member the homestead will in most cases no longer be regarded as a "homestead", and thus be treated as a counted resource after "permanent institutionalization." See 907 KAR 1:645 §3(1)(b).

(1) Administrative allowances – in addition to the above exceptions to this rule, policy permits the recipient a time allowance to sell the property during which it may be excluded from consideration. In essence, an individual who is in the process of marketing the property for sale may become eligible for Medicaid during the period while the property is on the market, and a "reasonable effort" is made to sell the property. See907 KAR 1:645§3(3)(b)(2).

(b) Exceptions to sale requirement.

(1) Jointly owned property. In cases where residential property was jointly owned prior to the effective date of the new law, so long as co-owners refuse to relinquish their portion and thus facilitate a sale, the property may continue to be excluded at least for cases where the recipient's eligibility was prior to 9/1/2003.

(i) This may be a "Pyrrhic victory" however. Eligibility may be maintained, but the recipients' interest in the property may be subject to estate recovery.

(ii) The addition of another person's name to residential property constitutes a transfer of resource.

(2) Special situations. The homestead may be excluded in the following cases –

(a) Where the property continues to be resided in by a spouse or dependent family member;

(ii) For the first six (6) months of the recipient's institutionalization;

(iii) For up to the 1st recertification (possibly even longer depending on the facts and circumstances) where the recipient has signed a statement to the effect that he or she intends to return home within a specified time.

(iv) The home has been owned by, or transferred to, a specified class of individuals under 907 KAR 1:650 Section 2-

a. the recipient's spouse;

b. the recipient's child under age 21

c. a caretaker child who has resided with the recipient for two years prior to institutionalization and who provided care to the recipient to prevent institutionalization;

d. a disabled child of the recipient.

e. A sibling of the individual who has an equity interest in the home and who has lived with the institutionalized individual for one year prior to institutionalization.

(c) <u>What to do ?</u>

(1) Transfer house as an advance plan well before need for long-term care.

(2) In situations where there is not sufficient time, it may be advisable to sell all, or a portion of, the house to children for assessed value which may be less than market value.

(i)It may also be advisable to sell for less than assessed value – this would trigger a gift penalty, however, which will need to be considered.

(3) Retain life estate; transfer remainder.

(a) This technique will permit a reduction in value of what has been sold. The manual has tables at Section 2056 which establish the value of a life estate and remainder interest. Consider –

<u>Example #1:</u> An 80 year old woman has a house which is tax assessed at $100,000. She retains a life estate and sells the remainder to her children. Her life interest under the tables is worth 43.66% of the property, or $43,660. The children then purchase the remainder interest for $56,340. Through a combination of gifts and private pay spend down, assume she consumes $6,000 per month. In 10 months she is eligible because the funds are gone

<u>Example #2</u>. Same example, but children purchase the remainder for half, or $28,000. There has been an uncompensated transfer (gift) of $28,000. Assume the transfer

factor was $2,800 in the year of application. Transfer penalty will be 10 months.

(ii) Assume the children pay nothing. Penalty will be 20 months. Query: how will 20 months cost of care be paid? May need to retransfer property and start over. See CMS Regulation 3258.10 for "curing" prohibited transfer penalties.

(d) Income tax considerations .

(1) Where property must be sold, consider sale of property in recipients' name for capital gains tax exclusion where recipient has lived at property for at least one (1) of previous five years. The normal 2 of 5 years is relaxed where a person has been in a nursing home. In such cases it may be possible to exclude up to $250,000 captial gain for a single person ($500,000 for a couple) as "personal residence" under Internal Revenue Code Section 121(d)(7).

(1) If property is transferred to children who then sell, children will pick up recipient's adjusted basis, which often is quite low relative to current market, thus creating current tax liability to children.

(i) Property may be transferred to individuals who plan to live there without tax concerns if the intent is for it to become their residence.

(3) Query as to whether property which is subject to retained life estate will enable heirs to receive stepped up basis under Code Section 1015 based on inclusion in estate under Code Section 2036.

E. ESTATE RECOVERY

1. Expansion of estate recovery. Under post-August 31, 2003 rules, estate recovery is no longer limited to the recipient's "estate" as defined for purposes of state probate law, but purports to embrace any and all interests in property which the recipient owned at death. Thus, even survivorship property, property in trusts, and - interestingly - life interests are to be made subject to new estate recovery rules.

2. Planning to minimize damage. In the wake of the new rules, recovery may be more expensive than appears.

Example#1: Recipient owns property in joint survivorship with children in a pre-September 1, 2003 deed for a pre 9/1/2003 approved case. Assume the property is worth $200,000. Mother dies. Property may be subject to estate recovery claim for $100,000.

(a) Transfers prior to eligibility. As always, advance transfers prior to recovery ought to be considered where time permits. Thus, even where a transfer may extend an eligibility period, the advantage to removing a property interest from estate recovery claims should be weighed in the decision making process.

(b)Transfers after eligibility has been established. In this situation what is assumed is that one of the exceptions to requiring sale of the property (which has been discussed earlier) applies. Now that the individual is on Medicaid, the focus shifts to a consideration of what can be done to protect the property from recovery.

(1) Cost of recovery exposure versus cost of discontinuance of Medicaid must be taken into account. Following cessation of Medicaid, gifts can be made, or purchase for PVA value and recipient can go back on Medicaid after spend-down.

(2) Example#2: Same facts as example #1. Son purchases remainder interest of mother's half of the property for $56,340, mother goes off Medicaid for 9 months. If half property subjected to estate recovery at death, son could lose $100,000 to estate recovery claims instead.

3. Resistance to recovery claims.

Just because the government believes it has a claim doesn't mean that our clients have to acquiesce.

(a) Survivors not subject to deceased co-owners debts.There are a number of decisions and principles that a surviving co-owner of survivorship real estate is not subject to the debts of the deceased owner, at least where the creditor has not brought an action against the deceased co-owner prior to the deceased owner's death. See CJS Joint Tenancy §§2 and 37.

(b) Life estate recovery at death ? It is difficult to see what transfer occurs at the death of a life tenant. The retention of a life tenancy is an excluded resource under Manual Section 2055, with the result that the remainder interest is regarded as having been transferred. At the deceased recipient's death, the life estate simply terminates and there is no "transfer". Thus, what remains to be subject to claims ?

(1) Even if Medicaid can recover, the question becomes :*against what ?*
If property transferred when recipient was 81, and he dies at age 85, is the interest re-valued at the time of death based on life tables then?

PART TWO: PLANNING TECHNIQUES

A. OVERVIEW

Planning generally involves the process of reducing counted resources to be within the allowable limitations as discussed above in Part One. The most common planning takes the form of a combination of gifts, spend down, and conversion of counted resources to non-counted resources or income.

Simple gift planning and techniques have already been discussed in Part One, and will not be reviewed again here. This section addresses the form by which transferred resources are held subsequent to transfer from the standpoint of whether or not such form may be of use in a given situation.

In addition, in certain instances form is – if not exalted over substance – a condition to securing special eligibility qualification, i.e. "qualifying income trusts" and "special needs trusts".

B. PLANNING THROUGH THE USE OF TRUSTS

1. General rule. Because of the change in the law brought about by OBRA '93, any trust established after August 10, 1993, will be considered under the new transfer of resource rules applicable with respect to trusts. Self-settled trusts – i.e., those trusts created by an individual with his or her own assets for his or her own benefit, whether actual or potential - generally will prove useful only in a very narrow set of circumstances.

(a) Extended look-back. Transfers into trust have two unfavorable and complicating features. First, the look-back period is extended an additional 24 months – from the 36 months applicable with respect to outright transfers to a sixty (60) month look-back period. What is more, the first month commences with the date at which no distributions of all, or only a specified portion, of the trust can be made to the trust settlor. This is the case even if such distributions are made only in the discretion of an independent trustee. It would seem that it would be a rare circumstance where a self-settled trust would be a desirable planning technique, since such a trust entails a longer waiting period than an outright transfer, and affords the trust grantor/beneficiary/prospective Medicaid applicant minimized beneficial enjoyment of the trust property other than over a segment or a potential income interest only.

(1) Of course, even a gift made in trust is penalized based on the transfer of resource factor, which in 2005 is $2,685. Thus, the trust rule only extends the *look-back* period from 36 to 60 months. Whether the transfer will result in an extended penalty depends on the *amount* of transferred funds.

Example: Mother has $100,000 which she places in an "income only" trust in January 2006 to pay her income for life. She specifically relinquishes any access to principal whatsoever. Thus, there has been a transfer of principal which starts in January 2006. $100,000 divided by a projected transfer factor of $3,020 (using 2005 as a base year and assuming 3% COLAs each subsequent year) would mean that were an application made in January 2009 the penalty would have expired in October 2008. ($100,000 divided by $3,020 = 33 months from January, 2006)Therefore, a penalty on a $100,000Transfer into trust would not trigger any additional ineligibility period.

(2) Contrast this with the situationwhere $200,000 is transferred. A transfer into trust would expose the transferor to 2 additional years of ineligibility.

(b) Certain trusts receive favorable treatment.

(1) Special Needs Trusts – for disabled individuals under age 65 are a means to qualify immediately for Medicaid.

(2) Third party trusts – that is trusts created by someone other than the Medicaid recipient, a court, or legal guardian, or a spouse (other than a testamentary trust created by a spouse) – are considered according to availability to the individual seeking Medicaid. See 907 KAR 1:650.

(3) (iii) QITs – discussed below are not so much as a planning technique as an eligibility requirement.

C. SELF-SETTLED TRUSTS

Three general types are most typical: (i) A self-settled income only trust; (ii) a self-settled special needs trust; and (iii) a qualifying income trust.

(1) **THE INCOME ONLY TRUST**

(a) Usefulness

The Income Only Trust is usually compared against a direct gift of assets to children or other heirs. Generally speaking, where an individual has been financially independent, and is healthy, he or she may like to retain some but not all, rights to his or her assets and independence. With an outright gift, the funds are gone. If the individual wants money, he or she has to ask the donees. Also, when an outright gift has been made, the gifted funds would generate income to the donees which would be reported on the donees income tax return.

(b) Tax Features

With an Income Only Trust, the income from the assets would be paid from the trust to the trust creator ("the Grantor"), and is not taxed to the donees.

(c) Limitations

With an Income Only Trust, by definition the Grantor's rights would be limited to income, and he or she would not have an interest in the trust principal. If the document permits, the Trustee could have the power to distribute principal to persons other than the Grantor, which could then, if the distributees desire, be gifted back to him or her, or used to pay his or her bills.

(1) This may- although it should not - create problems as to issue of availability of principal funds as to the grantor.

(d) Security to Grantor

Before leaving the subject, consider the potential dangers of gifts made directly to children. For example, should a child run into creditor problems, the gifted assets might be subject to the claims of a child's creditors. Additionally, should the child predecease the trust Grantor, then the funds that have been given to the child might be subject to claims of a surviving spouse of the child, or would generally be available to the creditors or other claimants of a child through the child's probate estate. In this regard, if the Grantor wishes to restrict access to principal, the Income Only Trust offers him or herthe additional security that his or her money still remains available to provide for him or her, and no one else.

(e) Medicaid Effect

The creation of an Income Only Trust starts the Medicaid waiting period from the time assets are transferred into the trust. Upon the expiration of no more than (and possibly less than) five years from the date of the establishment of the trust, the trust principal should no longer be considered available to the Grantor. See section (B)(1)(a), above to the effect that the penalty is based on the amount of the transfer. If he or she requires long-term care, the trust assets should not thereafter prevent him or her from being eligible for Medicaid benefits. In other words, through the creation of the income only trust, the Grantor would be starting the time period which, upon expiration of five years at the longest, would mean that he or she would be "resource eligible" for Medicaid benefits should he or she require long-term institutional or home health care for which Medicaid benefits are normally payable. Properly drafted the trust should not be counted after five years. As stated earlier, the ineligibility period will depend on amount of transfer.

(1) Given the current low yield interest rate environment, such trusts may not be popular. If rates were to rise there may be a renewed interest.

(f) Tax Implications

(1) Estate and Gift Tax

The establishment of the trust may or may not be a completed gift for gift tax purposes, depending on what is decided. If the Grantor's estate is less than $1.5 Million, (in 2005) and there is some built in capital gain it may be advisable that he or she retain a general testamentary power of appointment over the trust assets which may be exercised in his or her Will. Basically, that just means that the Grantor retains the power to say who gets what at death. The advantage to the transfer to the trust's not being considered a completed gift is with the fact that where the gift becomes complete upon death, then the trust assets will receive a stepped up basis equal to date-of-death value. This would enable the trustee to liquidate the trust assets at that time *without realizing capital gains tax.*

(2) Stepped-up basis – income tax advantage

The trade off for deferring the completion of the gift to the time of death is that the assets would be includable in the taxable estate. As mentioned, the federal estate tax will only apply to estates which exceed (in 2005) $1.5 million dollars. In other words, if there is no estate taxation in any event, it may be advisable to structure the trust so as to get the step up in basis.

(i) Generally, where it is believed that a taxable estate not will be an issue, it is advisable to complete the gift at death which would afford the heirs with the ability to eliminate capital gains tax up to date of death. If it is believed that the estate will exceed the projected estate tax exemption in the year of death, then it may be advisable to complete the gift now. The federal gift tax exemption is $1 million. If the transfer to trust is a completed gift at the time of transfer, then that would lock in the heirs to the Grantor's basis in the property which may trigger the potential for significant capital gains when the assets are sold.

(ii) Caution may be advisable in drafting to avoid exposure to estate recovery.

(iii) Note: An incomplete gift for tax purposes can be a completed transfer for Medicaid purposes

(3) Income Taxation

From an income tax point of view, as stated earlier the trust should be taxed to the Grantor under the grantor trust sections of the Internal Revenue Code, IRC §§ 671-679. Where the Grantor retains a right to income for life, he or she will be taxed on the income generated by the trust assets.

This is an advantage in that a trust is normally taxable at more highly compressed brackets than is an individual. Of course, the trustee can control the extent of income generated, and the Trustee will not normally (in a well-drafted trust agreement) be limited by any requirement to make the trust assets productive of income. Thus, should the trustee design an investment portfolio which contains primarily growth securities which do not pay dividends and there are few income paying securities, income flow can be minimized or maximized as needs require.

(i) The trust could be established to generate higher income first which could later be minimized at such time as the Grantor applies for Medicaid benefits. Reason: Where the grantor goes on Medicaid, his or her income from the trust must be paid to the facility unless there is a possible community spouse income allowance.

(2) DISABLED PERSON'S ("SELF-SETTLED") TRUSTS

(a) Overview

In August 1993, OBRA'93 specifically sanctioned the use of a special needs trust established for the benefit of a disabled individual who is under 65 years of age even if that individual's own assets are used to create the trust. The grantor must be the disabled person's parents, grandparents, legal guardian, or a court. In certain instances, a non-profit organization can establish a trust pooling arrangement.

A so-called "disabled person's trust" is authorized under 42 USC 1396p(d)(4)(A) and 1396p(d)(4)(C), and is a means of qualifying for public assistance benefits a disabled individual who otherwise has excess resources and is thus not eligible Such trusts are exempt from transfer of resource penalty.

(b) Special applications

The trust beneficiary qualifies for available Medicaid benefits as soon as the funds are transferred into the trust and not used for the beneficiary's support. Note: Unlike the issue regarding third party funds (discussed in Section ***** below) what is involved here is a trust created with the disabled beneficiary's <u>own funds</u> which, once placed in the trust, are excluded from consideration. Thus by establishing a qualifying trust and converging assets to it, he or she can <u>immediately</u> receive governmental benefits. As to this type trust, there is no Medicaid ineligibility period. The trust may thus be established either well in advance of the time participation in a public assistance program is offered, or the day before.

(c) Personal injury awards, inheritance protection

(1) The Special Needs Trust technique can be used to shelter personal injury awards from spend down requirements Thus, where the person became injured and disabled in an act which was the source of a settlement or damage award a Special Needs Trust can be a useful device to protect the funds.

(2) Similarly, funds which a person receives by way of an inheritance can be protected through use of the trust.

(3) In addition to qualifying a disabled individual for Medicaid, such a trust can qualify a disabled beneficiary for Social Security SSI benefits during a certain phase, (so long as principal is <u>not</u> available at the beneficiary's demand; i.e., distributions from the trust are discretionary with the trustee) while containing a "trigger" provision that will qualify the disabled person for Medicaid benefits by shutting down all basic support discretion at such time as a care facility, group home, or other arrangement offers the beneficiary participation in a Medicaid program. For instance, a trust can contain a purely discretionary provision authorizing certain payments on behalf of a disabled beneficiary so as to render the beneficiary eligible for a monthly Medicaid card to cover that beneficiary's hospitalization and other health care benefits even though participation in a long term care program might be deferred until a future date. Then, at the future date when participation is available to the beneficiary, the trigger provision can scale back the trust to provide more restrictive benefits (i.e., supplement support only) to complete this important estate conservation technique. In particular, individuals who are awaiting eligibility in the "Supports in Community Living" program (the "SCL program") may find such a trust to be quite helpful on both a short and long term basis.

(d) <u>Qualification requirements</u>

(1) <u>Payback requirement</u>

In order to qualify the individual for Medicaid, the self-settled Special Needs Trust must contain a mandatory state reimbursement provision. The provision must specifically state that at death of the disabled person the trust property passes to the state to reimburse the state for medical assistance furnished the beneficiary during his or her lifetime.

(i) Exception if the trust is administered as a pooled trust by a non-profit organization, it may qualify for exemption.

(2) Substantive requirements

The other qualification requirements relate to the substantive or dispositive provisions of the trust.

(i) Unavailability to beneficiary. The trust must not be accessible by the beneficiary himself or herself, and must be from reimbursement to the state where the funds remain in trust for other disabled individuals a pure discretionary trust in the discretion of the Trustee. Further, the trust should contain a "no support" clause that prohibits payment of essential support or health care whenever such items are available, or potentially available, to be paid by Medicaid.

(ii) For the sole benefit of the beneficiary. The self-settled trust can not be made available to benefit anyone other than the beneficiary.

(iii) Age limit. Can not be created for, or added to after, beneficiary's reaching age sixty-five.

(iv) Class of grantors. Under the authorizing statute, there isa limited class of permissible grantors: the individual's parents, grandparents, legal guardian, or a court.

(v) Qualifying Income Trust Compliance In an interesting recent intepretation (some might say "misinterpretation")of the law, DMS staff have sought to apply QIT rules (discussed in the next section) to Special Needs Trusts. Thus, even though SNTs are specifically authorized under 42 USC Section 1396(p)(D)(4) which sets out the requirements, DMS has sought to engraft further requisites on the Congressional statute passed in 1993, with the result being that SNTs which do not comport with QIT rules may be rejected by Frankfort.

The author believes that DMS theory is simply wrong. QIT rules are intended to provide a framework whereby individuals with income in excess of the income standard (in 2005, $1,737 per month) must place their excess income in a QIT. The federal regulations on such matters, HCFA Transmittal 64, makes it clear that only income "of the individual" is subject to QIT rules. As to SNTs, so long as the income is that of the trust, and not the individual, QIT rule are inapposite.

NOTE: SPECIAL CONSIDERATION - As of this writing, the statutory language authorizing a disabled person's trust does not contain any guidance with regard to what happens in the event the disabled individual recovers from his or her disability and returns to independent living while assets remain in the trust. There is a question as to whether the disabled person may receive unrestricted principal benefits from the trust at that time, or thereafter, which will cause a substantial depletion or dissipation prior to such individual's death, thus cutting down or eliminating a state's right of recovery.

(vi) Subrogation Counsel preparing disabled person's self-settled trusts will often work with personal injury lawyers. In this regard, it is important to determine whether there may be an outstanding Medicaid subrogation claim against assets which are contemplated for placement in the trust. The matter of subrogation rights is not clear under Kentucky law, and it is possible under the so-called "made whole" theory of tort law that even in the wake of a large subrogation claim, the Plaintiff's lawyer may negotiate a reduced payment. Nonetheless the practitioner is alerted to KRS 205.629.

Although Special Needs Trust legislation facilitates future benefit eligibility subsequent to receipt of funds from a settlement or judgment, there may well be an obligation to repay Medicaid for benefits advanced prior to receipt of funds, even where the injured party never receives funds that are conveyed into trust. Failure to report funds may trigger harsh Medicaid penalties with respect to future or ongoing benefits. This matter should be reviewed with the client and personal injury attorney for guidance and risk evaluation.

(3) QUALIFYING INCOME TRUSTS –

In 2003 Kentucky joined the ranks of a handful of "income cap states". This means that individuals with income above a certain ceiling are not eligible for Medicaid, regardless of whether they are resource eligible.

(a) Definition – A "qualifying income trust" ("QIT") is a trust agreement which is established to receive income of Medicaid applicants/recipients whose income exceeds the income standard applicable under Kentucky's income qualification rules which changed on September 1, 2003. QITs are not a planning device as much as a compliance requisite. In effect, any individual whose income exceeds the annual income standard (in 2005 it is $1,737 per month) must place his or her income in excess of this amount in the QIT, and by so doing the individual will no longer be income ineligible.

(1) Resource eligibility is still required. In other words, the trust does not create eligibility. Resources are NOT placed in the trust. The trust is a vehicle to receive income.

(b) Requirements – Under 907 KAR 1:650 Section 3(5)(a)-(g), a QIT must contain the following provisions –

(1) All income of the trust will be regarded as "patient liability" and thus must be distributed currently toward the patient's cost of care unless under the relevant facts use of funds for allowable deductions such as dependency deductions (i.e. community spouse) is allowed by the DCBS caseworker.

(2) The trust must be irrevocable.

(3) Only income *above* the annual income standard *must* be placed in the trust.

(i) Thus, in cases where income is $2,037 per month, only $300 must be placed in trust. The first $1,737 can keep coming in to the same source as always.

(4) At the death of the recipient, any accumulated income which has not been paid must be paid to the state.

(5) The trust must terminate only at the recipient's death.

(i) Query as to what happens if the patient recovers? This is not addressed under the regulations. Presumably the recipient's income would then be directed away from the trust.

(6) The trust must be notarized. This has been a strict requirement of DMS policy makers.

D. THIRD PARTY TRUSTS -

1. Overview. In this section, we will examine trusts created with funds not belonging to the Medicaid recipient. In keeping with general principles, such trusts are generally considered according to availability to the individual. See 907 KAR 1:650 for guidance.

(a) Two general drafting principles. As an overall rule, in drafting for such trusts, it is wise to keep in mind two fundamental principles:

(1) Make the trust a discretionary trust. In other words, do not give the beneficiary unlimited access to the trust. Vest discretion exclusively in the Trustee as to such amounts, if any, of income and/or principal that will be paid to or for the benefit of the beneficiary.

(i) If creating a trust for the surviving spouse, even if it is intended that spouse be Trustee for himself or herself and given latitude over disbursements, such powers should be subject to cut back in the event of spouse's incapacity or institutionalization.

(ii) Better option would be automatic removal of spouse from being Trustee in the event of such events as described in (i), above.

a) Further if spouse is elderly or disabled, may wish to use one other than spouse as Trustee.

(2) Incorporate Trust Protector provisions. Though such trusts are typically irrevocable by beneficiary, it is wise to confer upon a non-beneficiary (or not-current beneficiary) the power to amend the trust to comport with changes in the law or the interpretation of the law subsequent to establishment of the trust.

(2.) THIRD-PARTY SPECIAL NEEDS TRUSTS -

(a) Overview - An important exception to the available resource rules applies in the context of a trust created for the benefit of a potential Medicaid recipient other than the individual who is the grantor, or his or her spouse. Where the funds utilized in the establishment of a trust have originated with the Medicaid applicant, his or her transfer is generally going to be either disregarded and the trust funds counted as available, or the transfer will constitute a transfer of resources which will result in a period of ineligibility, as determined by the look-back rule unless the special needs trust exception applies. See 907 KAR 1: 645 for treatment of trusts and transfer of resource policy. Trusts created for oneself that may receive special exclusionary treatment are not the subject of this section, but are discussed more fully in Section 5, below.

(1) Created by non-recipient party
The third party trust referred to in this section contemplates a trust agreement which is created by a third party (i.e., one other than the prospective Medicaid recipient) with assets which have originated at all times *with the third party*. In other words, this section will focus on trusts established by a third party which, at the time a Medicaid application is made, are not regarded as having been created by the Medicaid applicant, and where the trust assets are not regarded being available resources to the Medicaid applicant.

Example: Father creates a trust for his daughter, a handicapped individual. The trust will be funded with the father's assets. The trust is, as to the daughter, a third party trust.

(2) Typical Grantor(s)
In particular, at this point consideration will be with the need for responsible family members to take into account how to best plan for those who may be dependent upon funds which will be set aside either for dependent survivors at the death of the third party; or be set aside for dependent individuals who are categorically eligible for benefits, and resource eligible based on their own resources, but the third party wishes to establish a source of supplemental support as to such individual in such a manner as to not preclude public assistance benefits from being available to such person, referred to herein as the "disabled person."

(3) Purposes
In all events, planning will emphasize the need for structuring the funds so set aside in order that such funds constitute only a "supplemental source of income," of the

disabled person with the result that any funds as to that individual will not be regarded as available resources, subject to spend down limitation rules as a condition to the disabled person's continuing eligibility for Medicaid benefits, or anticipated eligibility for such benefits. Thus, the primary issue relating to third party trusts centers on whether the trust assets are "available" to the disabled person/Medicaid applicant.

(b) "Supplemental Support" Trusts

The key to understanding the rules of third party trusts is that such trusts must be written in such a way that at all relevant times, the assets and/or income therefrom will not be available to meet the disabled person's basic cost of care, including institutional care, or generally the type of services which are normally covered by public assistance programs.

A "special needs trust" or "supplemental support trust" can take two forms: (1) a "pure" supplemental support trust; and (2) a so-called "trigger trust."

Included among the definition of items which go towards a disabled person's "special needs" or "supplement support" are those items which are not necessary to provide for the disabled person's basic needs, including room and board in an institution or other facility, or under circumstances where governmental benefits are payable. Special needs would include such items as entertainment, vacations, travel, audio and visual entertainment, non-essential clothing, and generally all other items which may provide for a beneficiary's enjoyment of life but which are not among the beneficiary's essential needs.

(1) "Pure" supplemental support trust - This is a trust which, by its terms, is at all times limited to making disbursements which are strictly to provide for a beneficiary's supplemental support or special needs. The trust does not authorize distributions for a beneficiary's general health, maintenance, and support, even where such distributions are discretionary with the trustee. Such a trust is normally confined to circumstances where a beneficiary is already disabled and receiving public assistance. Neither the trust corpus nor income of such a trust would be considered available to the beneficiary in the determination of his or her eligibility for benefits.

(2) Trigger Trust – This is a type of trust which provides that the trustee may, in the trustee's sole and absolute discretion, apply so much of the trust income and/or principal as the trustee deems advisable to provide for the beneficiary's reasonable health, maintenance, and support. However, upon a beneficiary's application for public assistance benefits to be applied towards the cost of providing for the beneficiary's

institutionalization or other care of a sort for which governmental benefits for the beneficiary's health care become and remain, payable, then, at that time, the trustee shall no longer have the authority to distribute to or for the trust beneficiary any amounts from the trust income or principal which may supplant or displace public assistance benefits. Thus, when the Medicaid application is made the Medicaid application(or eligibility, as the case may be) triggers the restrictive supplemental support provisions of the trust, and no distributions may be made other than for the purpose of providing for a beneficiary's special needs, or supplemental support.

(i) Under the current regulatory system, a third party special needs trigger trust will generally not negatively affect a beneficiary's eligibility for public assistance, provided that::

a) the Trustee is never required to distribute income or corpus to be applied toward the beneficiary's health, maintenance or support;
b) the Trustee's power to even make discretionary disbursements for health, maintenance and support is shut down upon the application for public assistance benefits. So long as benefits are paid, the Trustee has no power to make disbursements which supplant or displace same. Some flexibility may be inserted in the language of trust such that "insubstantial" public assistance benefits, (usually small cash assistance payments such as SSI) may be disregarded if the beneficiary has needs which are not being met by those benefits, and the trust fund could meet those needs;
c) The potential special needs beneficiary should not have a definable interest in the trust;
d) Ideally (but often this is not practical) a person who has a support obligation to the special needs beneficiary should not be trustee, especially if someone else is available.

(ii) Comparison of Trusts

This author tends to favor third party trigger trusts over pure supplemental support trusts, as the former are much more flexible to a given set of facts. Such trusts require more intensive management, particularly as the Medicaid beneficiary's situation changes, so as to not make a prohibited distribution during a relevant time.

(3) Administrative Issues

Even should such a distribution be made, if spent before that month end, the Medicaid rules of "administrative feasibility" may not necessarily result in a disqualification.

(i) Trigger trusts can be adapted to a class of beneficiaries, including non-disabled beneficiaries, thus facilitating broadly permissible support distributions to some beneficiaries, while restricting distributions to others.

(ii) A trigger provision is commonly utilized where a beneficiary does not at present have a life situation which requires the beneficiary's institutionalization or other long term care, but in order to be responsive to circumstances which, by virtue of the passage of time, and a change in life situation, the need for estate planning and trust administration can become compellingly important.

(c) Special Needs Provision

(1) Override Provision

For the above reasons, an override provision in the trust document may be advisable.

(2) Indirect distributions

Whether the trust is a pure, special needs or trigger trust, some other technical aspects of the trust should be drafted for. Included among the special needs language, should be a proviso that any beneficiary who is eligible for public assistance benefits will never receive payments directly from the trust. Thus, distributions from a special needs trust should preferably be paid to third parties on behalf of the beneficiary and limited to those expenditures that cannot be considered to be, or converted to, food, shelter, utilities, or essential clothing.

(3) Note that in-kind and indirectly paid support items will reduce SSI payments generally up to a maximum reduction in SSI by 1/3.

(d) Trust agreement vs. testamentary trust

(1) OBRA '93 specifically sanctioned a third party testamentary trust for the benefit of a spouse. This should not be relevant for a disabled non-spousal beneficiary. Query as to whether an inter vivos trust agreement created by a third party can provide supplemental support for a beneficiary and come within the protection of the statute. Does this mean that revocable trusts should be collapsed at death and poured over to a testamentary trust? At this point, the solution which is advocated is the grant of authority via specific powers given to the executor to create a testamentary trust and receive such a

distribution from an inter-vivos Trustee, even if that means re-opening the estate, if necessary.

(i) In cases where the trust beneficiary is not the spouse of the trust creator, the trust should not present problems. Where the surviving spouse is beneficiary, arguably the exception to transfer penalty under Manual Volume IV A Section 2010(B) (2) may not apply to a living trust versus a testamentary trust, since that section appears to limit the exemption for trusts for a spouse to trusts created "by will." This exemption *should* be construed to apply to trusts which create benefits upon death of a spouse, as opposed to benefits while the non-applicant spouse is living.

(ii) If the government is stingy and refuses to cover inter-vivos trusts which come into effect after the death of the creator spouse, perhaps the most compelling argument is with the fact that the trust was not created for the purpose of gaining Medicaid eligibility. The transfer occurred upon and came into being by reason of the spouse's death, which was not motivated by Medicaid eligibility reasons. See also Manual Volume IV A, Section 2105 for an analogous situation.

E. CONVERTING ASSETS TO INCOME – ANNUITIES

1. Overview

(b) Caveat

Recently, although this author believes erroneously, the Kentucky Department for Medicaid Services ("DMS") has challenged annuities acquired close in time to Medicaid application date. The reader is advised to proceed with caution in using this technique. Under policy adopted late in 2003, all annuities must be reviewed by DMS staff in Frankfort which has begun to deny eligibility where annuities were acquired on the eve of Medicaid application. The rationale of DMS is that where a Medicaid purpose is clear, annuities are abusive means of evading transfer penalties. This is in contrast with Federal Rules, under the CMS Manual and Kentucky Administrative Regulations which provide that if actuarially sound, non-transferrable and irrevocable, the transfer is not counted and the funds are no longer considered a resource.

(c) May be only option. In certain instances, if time is of the essence and there are no other alternatives, an annuity may be advisable, depending on the client's risk sensitivity.

(d) The rationale by which the purchase of annuities is not a transfer of resources.

The reader will recall that the transfer of resource rule triggers a penalty period of ineligibility in connection with a transfer made for less than full and adequate consideration. Although this rule operates generally to attach a penalty period to most transfers, transfers for adequate consideration are thus not subject to a penalty. Perhaps the most effective device to utilize the "adequate consideration" option is the Private Annuity, which is nothing more than a transfer of assets in exchange for a payment of income...a conversion of assets to income Such a transfer, properly structured, should enable the transferor to become eligible for Medicaid benefits immediately, without any penalty period whatsoever, so long as the transfer results in the transferor receiving annuity payments which are "actuarially sound" as deemed by the Kentucky Medicaid regulations. In effect, the technique should be viable in that the property transferred in exchange for the annuity is transferred for consideration (i.e., the annuity payment) which is worth an amount precisely equal to the value of the property transferred.

(e) Life expectancy tables have been set forth in the CMS regulations, and such tables must be taken into account in determining the amount of the annuity payout. The tables are set out at Manual Section 1890 and 1900.

> Example: Mrs. Smith, age 72, is institutionalized and has been told that à Medicaid bed is available to her. Under the CMS regulations, she has a life expectancy of 13.99 years. Thus, payments under an annuity cannot be established under a fixed term of years which will extend significantly beyond her life expectancy, or the arrangement will be deemed to be not actuarially sound. If not actuarially sound, adequacy of consideration will be questioned, and a possible gift element will be involved.

2. Commercial annuities. Annuities purchase from a normal commercial annuity issuer (typically a life insurance company) may satisfy the rules, however a VERY CAREFUL examination must be made of each annuity.

(a) Qualification Considerations

(1) Does the annuitant have access to principal ? If so, no matter what limitations there may be, the annuity will likely be counted as a resource.

(2) What is the term ? If it is not actuarially sound – i.e., a guaranteed term of years – there will be a problem.

(3) Is it irrevocable and non-transferrable ? If not, it will count.

3. Private annuities. A private annuity is an annuity but the obligation to pay is not made by an insurance company, but by an individual. Private annuities are quite complicated, and in this author's experience should be undertaken only as a last resort option when there are few other options. The reason : the transaction entails serious legal obligations over a protracted period of time, which clients frequently don't have the stomach for . However, in the right situation they have their merits.

(a) Mechanics - Those familiar with the estate planning utility of a Private Annuity know that the arrangement is a means of converting assets into income, whereby the individual transferring assets (known as the "annuitant") transfers assets to another individual (the "obligor") in exchange for the obligor's commitment to make payments back to the annuitant, either for life, a term certain, or a term of years as determined by reference to the annuitant's life expectancy, the last of which is known as a "Private Annuity for Term of Years" or "PATY." Essentially, the Private Annuity operates just like a commercial annuity purchased through an insurance company, or other financial institutions offering annuities; however, the difference is that the private annuity arrangement is between individuals not normally engaged in the business of providing annuities, typically family members. Thus, the arrangement is referred to as a "Private Annuity."

(b) The way it works is as follows.

(1) Transfer of assets - the annuitant irrevocably transfers assets to the obligor. Upon transfer, the transferred assets then belong to the obligor. For reasons discussed below, clients should earmark a specific account, or portfolio, where the transferred assets can be segregated from other assets of the obligor.

(2) The annuity agreement sets forth the obligation - A written agreement should be prepared to recite and set forth the annuity obligation, specifying the amount of the payout, the term of the annuity, and the disposition in the event of the death of the obligor. Some key points are as follows:

(3) Investment element - For the transaction to hold water insofar as Medicaid eligibility is concerned, not only is there a requirement that the term of the annuity be actuarially sound, but the payment must reflect a return on investment which is reasonable.

(4) Purpose - starting with the post-June 2003 rules, Kentucky bureaucrats have been – this author believes without proper authority – looking at the purpose of the annuity: was it to gain Medicaid eligibility? If so, even a properly structured transaction may, depending on circumstances, be disrespected, with the result that resources so transferred may be considered subject to transfer of resource penalty; or the funds may be considered to be a "resource."

(i) This approach to denial of eligibility should, as a technical matter, be baseless. Even CMS, speaking of "purpose" states that it must be viewed in light of actuarial soundness. If DMS' theory is correct – that a transfer is deemed as having occurred, what is it that has been transferred when the annuity is actuarially sound? Where is the failure of fair market value? If the transfer is disregarded altogether, i.e. the funds are considered a "resource", what of the fact that the funds are not available?

(5) Disposition at death - Typically, at death the annuity obligor's payment obligation would simply cease, and the assets transferred pursuant to the obligation would remain with the obligor. As an alternative, the annuitant may set forth a beneficiary designation in the private annuity that directs the disposition of any payment obligation which may survive him or her.

(6) Power to amend - As of this writing, as is true with regard to trust amendatory powers, it is prudent to authorize the obligor (not the annuitant) to collapse the annuity and return funds to the annuitant should either the arrangement cause the annuitant to lose eligibility for Medicaid benefits for any reason, or if the funds transferred are regarded as available to the

annuitant. A collapse should give the obligor power to commute the remaining payment obligation to its present value. Note that the annuitant must NOT have a power to access the principal.

(7) Why it should work - "actuarial soundness" - In theory, the annuitant no longer has a resource to the extent of funds transferred, but an income stream that will result in consumption of the asset so transferred based on the individual's life expectancy.

(c) Tax consequences - The tax consequences which flow from the arrangement are as follows:

(1) Income tax aspects - The annuitant will receive taxable income with respect to a fraction of the payments, since a portion represents a return on investment, and a portion represents a return of contributed capital. The obligor will be taxed on earnings from the funds transferred to him or her in exchange for the annuity payments. A discussion of the income tax aspects of annuities is beyond the scope of this outline, however, the practitioner is referred to Section 72 of the Internal Revenue Code. Basically, the practitioner should determine the expected payout over the life of the annuity, divide this by the amount contributed, and determine a return of contribution, and anticipated return on investment. This results in a fractional share which should be multiplied by each annuity payment to arrive at the amount which is taxable income for the year.

(i)It should be noted that regardless of whether the amount transferred is invested by the obligor in a tax free obligation, the annuitant nonetheless must report his or her return on investment as determined in Section 72. Typically, in the context of individuals interested in Medicaid eligibility planning, this will be a fairly small amount, and generally will be immaterial since the annuity payment will be applied toward the cost of long term health care, and therefore tax deductible at any rate.

(ii)Where assets other than bank deposits, certificates or deposit, or cash equivalents are part of the arrangements, the obligor will receive the annuitant's basis in the assets, with some adjustment, as determined by applicable IRS basis rules under Section 1014 and 1015 of the Internal Revenue Code.

Caveat:: The annuity may be structured so that any unpaid amounts at the annuitant's death will be paid by the obligor to named beneficiaries. Where large amounts are involved, if the annuitant dies before receiving all payments, if the obligor simply keeps the funds transferred and is relieved of the annuity obligation, there may be taxable income to the obligor in the year of the annuitant's death to the extent of the unpaid annuity amount. See Revenue Ruling 55-119. Having the unpaid balance paid by way of a beneficiary designation or general testamentary power of appointment retained by the annuitant may, properly designed, cause the annuity to be includable in the annuitant's estate and thus pass to heirs from the annuitant, possibly avoiding income taxability to the obligor.

(2) Gift tax aspects - Structured properly, the transaction is a sale of assets for valuable consideration, and not a taxable gift. Thus the transfer of funds from the annuitant/Medicaid recipient to the obligor is without transfer tax consequences.

(3) Inheritance tax aspects - Depending on how it is structured, the annuity may avoid estate taxation. If the assets were acquired during lifetime for consideration of the annuity promise, the obligor should receive the assets at the death of the annuitant free from Kentucky inheritance tax, or, where applicable, federal estate tax. The latter will rarely, if ever, be involved, except in those unusual instances where the annuitant has already used up his or her unified credit, and enters into a private annuity transaction and dies with a payment obligation outstanding. Such an annuity should not be covered by Section 2039 of the Internal Revenue Code, and in this author's view is not required to be reported on IRS Form 706 under the IRS instructions.

(d)Uses and limitations

(1) Generally - An annuity in the context of estate conservation planning is quite useful in two very important respects. The first is that the arrangement is a means of taking a Medicaid bed when offered when

transferred resources would preclude making a Medicaid application. Secondly, the structure is a means of slowing down the dissipation of resources.

(2) Limitations - The arrangement may not provide the family with the perfect financial solution to the cost of care, since the annuity income will, with some small allowances (notably personal monthly needs and the cost of health insurance), be regarded as patient liability, and thus turned over to the nursing home. Over a long period of time, the transferred funds will, in fact, be dissipated. Yet, in situations where there is no time to plan, and assets will be consumed in any event, the private annuity can give the family a chance to receive an inheritance. Even in smaller estates where a Rule of Halves transfer will facilitate eligibility in a relatively short period of time, there will still be a waiting period before eligibility can be established. A private annuity can eliminate the waiting period. As a rule of thumb, this technique will provide maximum benefits where the client is on the relatively younger end of the elder client spectrum, especially where the annuitant's actual life expectancy is not very long. A payout of fourteen years with good investment performance can slow down the rate of consumption of $100,000 assets to $8,000 per year, versus $30,000.

(i) For elderly single persons, the annuity payments amy approach monthly cost of care and be of little avail.

(ii) Typically works best for community spouse situations.

(e) Private versus commercial annuity?

For several reasons a private annuity offers advantages over a commercial annuity.

(1) No sales load - typically, insurance companies charge a hidden fee which is built into the return.

(2) Flexibility - since the transferred funds remain in the family, if the annuitant ever needs more money, there is a pool of assets which can be used for him or her. This may especially be critical if the annuitant is on Medicaid for a while, but then goes off the program, returning to personal care or independent living. With an irrevocable commercial annuity (remember, to be effective the arrangement must be irrevocable) that flexibility is not there.

(3) Opportunity for growth - if the family gets good investment performance, it is possible that the yield on transferred assets will result in growth, rather than consumption. In low interest times where the applicable federal rate is low, funds may be able to generate the payout on earnings alone, thus preserving the principal for the family.

(4) Can work for liquid assets – Assets can be transferred in kind rather than sold and then have to pay taxes before writing a check to an insurance company.

TOP 10 MYTHS CONCERNING LONG TERM CARE/ MEDICAID ELIGIBILITY

by

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1. ***If you make a gift, you must wait for 3 years before applying for Medicaid.***

This myth is the result of the confusion between the 3 year look back rule with the ineligibility period. In its essence, the 3 year look back rule is merely a point in time determined by reference to the date a Medicaid application is made and how far back the government can go to assess gifts made with a corresponding penalty. Basically, the ineligibility period is determined on the theory of how long a person, transferring funds, could have paid for long term care had he or she kept the funds. The ineligibility period will depend on the amount of the gift.

The gift is divided by the transfer of resource factor established during the year the Medicaid application is made. In 2005 in Kentucky, that factor is $2,685.

Thus, a gift made 1 full year before the Medicaid application is made in the amount of $26,850 will, assuming the application is made in 2005, trigger a 10 month penalty, which would have expired at the time the application has been made.

2. ***Gifts in the amount of $10,000 per person per year are not counted.***

This myth confuses the gift tax annual exclusion (which, prior to 2002, had been $10,000 per person per year, and is now $11,000 per year. This is simply a gift tax matter), with the Medicaid transfer of resource rule. There is no allowable minimum gift amount under Medicaid rules, however, a gift made which is less than the transfer of resource factor (see answer to question 1, above) will result in a zero (0) month penalty.

3. ***It's always a good idea to transfer the house from parents to children.***

Prior to September 1, 2003 there were very few cases, if any, where it would make sense to transfer residential property. Residential property had been excluded as a resource, and the transference of such property out of the Medicaid recipient's name would result in the loss of the exclusion, and would also trigger a penalty period. Simply stated, transferred residential property is essentially the equivalent of a gift.

However, due to new rules effective September 1, 2003, after an individual is institutionalized for six months, the house is considered non-homestead property which loses its exclusion in most cases. Thus, the property will need to be put up for sale unless one of the following exclusions applies. The exclusions are :

(a) the property is resided in by a spouse or a minor or disabled child of the Medicaid recipient;
(b) the property has been transferred to a disabled child of the recipient;
(c) the property has been transferred to a child of the Medicaid recipient who has lived with the Medicaid recipient for two years prior to institutionalization to provide care to the recipient to prevent institutionalization.
(d) the property has been transferred to a sibling of the Medicaid applicant who has an equity interest in the property and who has resided with the applicant for a year or more.

Transferring the house to children can create significant income tax problems to children upon the sale of the property subsequent to the parents' death. For the disabled child exemptions it may be prudent to sell the house in the Medicaid recipient parent's names if parent has lived in house for 1 of previous 5 years to exclude gain from income tax recognition.

4. *It is possible to shelter investments through a trust.*

Although in certain instances it is possible that a trust can be a means to shelter resources (Special Needs Trusts and income only trusts) any assets – with the exception of excluded resources other than homestead property- transferred into trust will either trigger a transfer of resource penalty (so long as the Grantor relinquishes rights to all or a portion of the trust) or be of no consequence until withdrawn (as in the case of a typical revocable trust) . The only true exception is in certain limited cases where property is transferred into a Special Needs Trust which can avoid transfer penalties, subject to specific rules.

In certain instances, transfers into trust may actually ***extend*** the Medicaid ineligibility period from 3 to 5 years since trusts trigger a 5 year look back penalty. It depends on the amount of assets and what is desired by the trust Grantor.

There are certain kinds of trusts - known as Income Only trusts - into which funds can be transferred for individuals who wish to place restrictions on the use of principal until after the Medicaid recipient's death. Such trusts must be approached cautiously, and funds placed in such trusts are subject to a 5 year, rather than a 3 year, look back period.

Transfer of any assets into a trust in which the Medicaid applicant retains a right to principal of the trust can result in a far extended Medicaid ineligibility period.

5. ***If one spouse is in the nursing home, the assets of the spouse living at home can be protected.***

While it is usually possible with some planning to protect the funds of the non-institutionalized spouse (referred to as the "community spouse"), there is a limit known as the "Community Spouse Resource Allowance" or "CSRA" that can be protected for the community spouse. All non-excluded resources in excess of the CSRA must be spent, transferred, or otherwise converted into non-counted resources before they can be protected for the community spouse.

Effective June 1, 2003, the CSRA is half the counted resources - up to a maximum of $95,100 in 2005, with a minimum of $20,000. The maximum changes annually based on COLAs per social security rules.

CAUTION : VERY IMPORTANT: The point at which the allowance is determined is when the individual is institutionalized and has made application for a "resource assessment" which can be a Medicaid application. In other words, before the CSRA can be determined, the individual will have to first have a "snapshot" of assets taken to the Medicaid caseworker (the government caseworker NOT the nursing home social worker or staff employee).

> Example: John and Jane Doe have combined assets of $100,000. John is in a LTC facility, and Jane lives at home. Jane hears that she can keep half the assets.
>
> She thus pays for 2 pre-arranged funerals for $20,000 and spends $30,000 on nursing home care. She goes to apply for Medicaid, believing John is now eligible. After all, she read that she can keep half the assets.
>
> Problem is that when she first goes to caseworker she has $50,000. She is told that she can keep ½, or $25,000.
>
> What she should have done was to have gone to the caseworker and get a resource assessment when she had $100,000. She would have been told she could keep $50,000, and then work from there to get John eligible.

6. ***If one spouse goes into a nursing home, the other spouse living at home must help to pay the nursing home costs for the institutionalized spouse.***

The non-institutionalized spouse may keep all of his or her income. In addition, if the non-institutionalized spouse's income is less than a particular year's "Community Spouse Income Allowance," then the community spouse may receive however much is necessary of the institutionalized spouse's income in order to bring him or her up to the Community Spouse Income Allowance. Effective July 1, 2005, the Community Spouse Income Allowance is $1,604 with possible shelter expense allowances.

7. ***Kentucky Medicaid eligibility determinations do not impose INCOME eligibility requirements.***

Previously, so long as the cost of care exceeded income, income was not a bar to eligibility. Starting September 1, 2003, however, Kentucky Medicaid has imposed an additional requirement of income eligibility for Medicaid recipients. Individuals with income in excess of $1,737 per month must funnel the income in excess of this amount into a special trust called a "Qualifying Income Trust". The trust must specifically provide that the income, less possible allowable deductions for spousal CSIA, health insurance premiums, and $40 monthly allowance, is to go to the nursing home.

8. ***Medicaid only counts half of jointly owned property.***

The rules on joint property are confusing, incomplete, and should not be relied upon. Generally, joint property is considered available to the Medicaid applicant if the Medicaid applicant may access the property. Under Kentucky law, that is true with respect to most nearly every kind of bank account imaginable. If the joint owner non-applicant's signature must be given in order to transfer the joint property, then Medicaid may count only half of such property. Joint bank accounts usually are available at the signature of either of the owners. Joint property is not something to rely upon where there is sufficient time to make other asset transfers or conversions which are far more effective.

One exception may be with respect to jointly owned real estate.

9. ***Medicaid does not count annuities as among the resources of the applicant.***

The problem with this general misunderstanding is that it is overbroad. Only irrevocable annuities that are actuarially sound, non-assignable, and contain a reasonable investment element may be excluded. Even then, however, although the annuity may not be counted as a resource, the annuity payments will be regarded as the patient's income and reduce or defray Medicaid cost of care where the annuity is owned by the Medicaid recipient.

This area is very volatile and planning through the use of annuities must be approached with much caution. I would advise against using annuities as planning devices unless there are no other viable alternatives or in situations where health care costs are prohibitively expensive.

10. Basically, the best thing to do is to transfer all money and wait for 3 years before applying for Medicaid.

This may or may not be the most advisable plan, depending on the amount of funds. If the amount of funds exceed two times three years' cost of care, then this is generally true. If a lesser amount is involved, usually a transfer of less than all will result in a shorter Medicaid ineligibility period. Also, through the judicious use of exclusions and conversions, it is generally far more likely to be that exclusions, conversions, and smaller transfers are a better way to go.